



INCENTIVES AND BENEFITS

Employee Stock Options – the Fallout From the 2010 Federal Budget

Anu Nijhawan, *Bennett Jones LLP*

Stock Option Cash-outs

Withholding Obligations

Relief for Capital Losses

As was the subject of various published articles, the 2010 Federal Budget contained significant changes to the regime in the Income Tax Act^[1] governing the taxation of employee stock options,^[2] which were anticipated to result in an increase of tax revenues of over \$1.6 billion over five years. At that time, however, taxpayers were left with unanswered questions regarding the true impact of the proposals and the compliance measures required.

With the enactment of the Budget proposals,^[3] the Canada Revenue Agency ("CRA") has since clarified its views on some of the issues and has implemented administrative procedures to deal with certain of the practical implications, which are summarized below.

Stock Option Cash-outs

One of the "tax benefits" associated with employee stock options is the availability of the 50% deduction from the amount of the stock option benefit under paragraph 110(1)(d), which effectively allows an optionholder "capital gains like treatment" on the stock option benefit realized. The 2010 Budget introduced measures which, for all stock option cash-outs after March 4, 2010, prevent an employee from claiming the 50% deduction on any cash payment received on the surrender of an employee stock option^[4] unless the employer^[5] files an election to forego its deduction in connection with the cash-out payment.^[6]

The original Notice of Ways and Means Motion contained various deficiencies. It did not provide guidance on the making of the employer election to forego the deduction (and hence allow the employee access to the 50% deduction) and appeared to allow such election only for stock options granted after the release of the 2010 Budget. It also appeared to contemplate that the employer election to forego the deduction applied to the specific grant of options covered by the election (rather than on a global basis to all grants). Those issues have now been rectified.

The applicable provisions of the Act clarify that the election can be made for all option cash-outs occurring after March 4, 2010 (notwithstanding when the options were originally granted) and indicate that the election is made on an employee-by-employee basis, rather than on a global plan basis. In particular, subsection 110(1.1) requires the employer election to be made in prescribed form filed with the Minister and requires the employer to provide the employee with written evidence of the election.

The provision further requires the employee to file the written evidence with the employee's tax return for the year in which the 50% deduction is claimed.

In answering the queries regarding the appropriate "prescribed form," the CRA introduced a revised T4 information slip, which requires the employer to make the appropriate election by reporting the amount of the stock option benefit in the "Other Information" area at the bottom of the T4 slip using code 86.[7] Provided this is done, the CRA has confirmed that the T4 slip will be the required evidence of the election and no further filings are required.[8] The CRA has also indicated the employer must advise the employee of the election at or before the time of the stock option cash-out, on the basis that the election will impact the quantum of source withholdings required.[9]

Somewhat surprisingly, however, subsection 110(1.1) applies to "all rights granted to an [employee] under an agreement to sell or issue securities," raising the issue of whether the election must be made with respect to all options granted under a single grant. The CRA has clarified their view that this election will apply to all of an employee's options under the same grant, including those which may be exercised in a later year. This raises a quandary for employers who thus have to make a once-and-for-all election as to whether a corporate level tax deduction will be claimed, even for options which remain outstanding at the time of the election. It remains to be seen whether the CRA will offer any administrative relief to those employers who made the election in 2010, on the basis of their understanding that such election would only apply in respect of the options cashed-out in that year – and not those which remain outstanding and are the subject of a cash-out in a later year.

Withholding Obligations

The 2010 Budget also significantly tightened the employer's obligations to make source withholdings in respect of stock option benefits. In particular, effective January 1, 2011, the employer's withholding obligations are to be determined as if the value of the stock option benefit (other than a benefit under a CCPC stock option governed by subsection 7(1.1)) had been paid to the employee as a cash bonus (subject to any reduction for the 50% deduction under paragraph 110(1)(d)). Further, the fact that the stock option benefit arose from the acquisition of shares will not be a factor to be considered in determining if there is undue hardship.

As a practical matter, most employers will likely satisfy this obligation by making source withholdings from cash remuneration otherwise payable to the optionholder, at the time the option is exercised or, alternatively, withholding a number of securities otherwise issuable and selling those on the market to fund the withholding tax liability.

Other practical issues as to how the withholding obligation can be satisfied where there is insufficient cash remuneration and no market for the securities subject to the option have not yet been addressed.

Relief for Capital Losses

The 2010 Budget also created a mechanism for elective relief where an employee had originally elected to defer the taxation of their stock option benefits pursuant to now repealed subsections 7(8) to 7(10) and was then in a situation where the acquired shares had decreased in value. The election is designed to ensure that the tax liability ultimately payable on the disposition of the shares does not exceed the proceeds of disposition on the shares, taking into account tax relief from the use of capital losses against capital gains.[10]

To take advantage of this mechanism, the employee must dispose of the subject securities by December

31, 2014 and file form RC310, *Election for Special Relief for Tax Deferral Election on Security Options*, by the due date for his or her income tax return for the year of disposition of the shares.^[11] It is not known whether the CRA will accept late-filed elections in this regard.

[1] R.S.C. 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the "Act." Unless otherwise stated, statutory references in this article are to the Act.

[2] In this article, "employee stock option" is used to refer to a stock option which is governed by the provisions of section 7.

[3] Bill C-47 received Royal Assent on December 15, 2010.

[4] Prior to the 2010 Budget, it was relatively commonplace for the stock option plans of public corporations (and mutual fund trusts) to permit optionholders to elect to surrender a vested option for a cash payment equal to the "in-the-money" amount of the option. The benefit of this approach was that the employee received the economic benefit of the stock option without having to come up with the exercise price and, so long as it was the employee's choice to surrender the option, also obtained the benefit of the paragraph 110(1)(d) 50% deduction from the stock option benefit otherwise realized pursuant to subsection 7(1)(b). From the employer's perspective, the tax benefit was generally a deduction for the amount of the cash payment, whereas a deduction would be denied, pursuant to paragraph 7(3)(b), for the issuance of shares on the exercise of a stock option. This resulted in a "win-win" from a tax perspective for both the employee and employer.

[5] Pursuant to subsection 110(1.1), the election must be filed by the particular qualifying person which granted the option and is made for both that qualifying person and any person not dealing at arm's length with the qualifying person.

[6] Subparagraph 110(1)(d)(i) and subsection 110(1.1).

[7] CRA Guide T4037 (January 5, 2011) and Guide RC4120 (October 18, 2010).

[8] CRA Publication 2010-11-24 (November 24, 2010).

[9] CRA website, "CRA 2000 Budget News – Employee Stock Options."

[10] Part I.01 of the Act, section 180.01.

[11] Provided that an individual files Form RC310 by his or her filing due date for 2010, an individual can also make the election for shares disposed of as far back as 2001.

Published in *Taxation of Executive Compensation and Retirement*, (2011) vol. XXII, number 6, page 1370

© Federated Press