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STOCK OPTIONS

The 2010 Federal Budget: Impact on the Taxation of Employee Stock Options

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While the 2010 Federal Budget, released by the Minister of Finance at 4 p.m. (EST) on March 4, 2010 ("Budget Date"), was relatively light on any tax-related changes, it did propose significant changes to the regime in the Income Tax Act[1] governing the taxation of employee stock options,[2] which are stated to result in an increase of tax revenues of over $1.6 billion over the next five years. The 2010 Budget proposals have already been the subject of extensive commentary which is not repeated herein. Rather, the focus of this article is a high-level analysis of the four main areas in which the 2010 Budget proposed modifications to the taxation of employee stock options, with a view to providing a framework within which employers can assess the need or desirability of making any modifications to existing stock option programs to deal with the proposals.

Stock Option Cash-outs

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 to the employee 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 and was a result which had received positive commentary by the Canada Revenue Agency ("CRA"), after numerous in-depth investigations.

The legislative landscape has now dramatically changed. The 2010 Budget introduces measures which will, for all stock option cash-outs after Budget Date, prevent an employee from claiming the 50% deduction on any payment received unless the employer files an election to forgo its deduction in connection with the cash-out payment. The Department of Finance has indicated that the measures are designed to ensure a comparable tax rate with that available on other compensation when considered on a total employer-employee basis, although it is questionable whether that result is achieved since, where the employer makes the election to forego the deduction, the employer loses a 100% deduction but the employee still pays tax on 50% of the benefit. In this context, "comparable treatment" may better have been achieved by denying the employer a deduction of 1/2 of the payment where the employee pays tax only on 1/2 of the payment.

While the proposals are stated to be applicable for all stock option cash-outs after Budget Date, it appears from the Notice of Ways and Means Motion that the employer election to forego the deduction (and hence allow the employee access to the 50% deduction) is available only for stock options granted after the release of the 2010 Budget. The effect is that employees who cash-out, after Budget Date, an option granted prior to the 2010 Budget, will be denied the 50% deduction, without any ability for the employer to make the election to forego the deduction. The writer understands, from informal discussions, that this was not the intent and that the amending legislation will, when introduced, clarify the ability for the employer to make the election to forego the deduction even for options granted prior to the 2010 Budget.[3]

It appears from the Notice of Ways and Means Motion that the employer election to forego the deduction (and hence allow the employee access to the 50% deduction) applies to the specific grant of options covered by the election (rather than on a global basis to all grants). As a consequence, it would appear permissible for an employer to make elections in respect of some employees but not others, although the practical ability to do this from a securities and employment law perspective is questionable.

From a stock option program plan perspective, in the immediate term, it would be advisable for employers to provide notification to employees of this change in treatment and, in particular, that an employee optionholder who elects to cash-out an option may well pay twice as much tax as an optionholder who elects to exercise the option for shares. The employer should also provide notice to employees of whether or not it intends to make any available elections to forego the deduction of cash-out amounts for any particular grant of options which has now vested and could be cashed-out.

In the longer term, employers should also consider whether or not their stock option plans should be amended to delete the ability of optionholders to elect to cash-out options, given that the tax benefits of this flexibility are no longer available. To provide employees with the same economic benefits (although without a deduction to the employer), employers could consider the implementation of an employer-sponsored cashless exercise program. Under such a cashless exercise, the employee optionholder would be permitted to use a broker to "short-sell" the securities to be acquired under the option prior to the actual exercise, with part of the proceeds then being paid to the employer in satisfaction of the exercise price and the remainder being paid by the broker directly to the employee (net of the broker's fees and charges). Upon receipt of the exercise price from the broker, the employer would then issue the securities to the broker who uses them to cover its position in respect of the short sale on the settlement date for that sale. Legally, the employee would acquire the securities, although they would be sold immediately thereafter and, pending further clarification in the implementing legislation, it does not appear that the 2010 Budget proposals would impact the availability to the employee of the 50% deduction.

Withholding Obligations

The 2010 Budget also proposes a significant tightening on the employer's obligations to make source withholdings in respect of stock option benefits. Under the current regime, while the employer has a technical obligation to make source withholdings in respect of income tax in respect of the stock option benefit, most employers rely on a long-standing CRA administrative concession to allow withholdings to be reduced to avoid "undue hardship."[4]

Pursuant to the 2010 Budget, 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*)) and 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. These new withholding rules are effective for all stock option exercises after 2010.[5]

As a consequence of the foregoing, employers will now be required to make source withholdings, from cash remuneration otherwise payable to the optionholder, at the time the option is exercised. The practical issue which is sure to arise in many circumstances is how the employer is to comply with this withholding obligation where the stock option benefit is in excess of ordinary cash remuneration paid to the employee in that period. If there is insufficient cash to meet the withholding obligations for the period during which the stock option is exercised, will the employer have to use its own funds to satisfy the withholding obligations? Alternatively, will the employer be required to withhold 100% of cash remuneration paid to the employee in successive pay periods until the required withholdings in respect of the stock option benefit are fully made?

Employers should examine the withholding provisions of their stock option programs to evaluate whether any additional powers are necessary. For example, it might be desirable for the plan text to contemplate withholding to be satisfied by the employer selling, on the market, some of the shares issued pursuant to the exercise of the stock option. Where the plan contemplates a cashless exercise of the sort described above, it would be worthwhile for the mechanism to contemplate a portion of the proceeds being sent directly to the employer to cover withholding obligations (perhaps as a condition of utilizing the cashless exercise mechanism). Arguably, even if the plan text does not explicitly contemplate these items, the employer should still have the ability to take such actions, given that they are necessary to comply with its withholding obligations under the Act.[6] Depending on the form of the implementing legislation, a further step may also be to include a provision allowing the employer to forestall the issuance of any shares pursuant to the exercise of a stock option until the employee has paid to the employer an amount sufficient to cover its withholding obligations.

Elimination of Tax Deferral

The third area in which the 2010 Budget proposes to alter the taxation of employee stock options is to eliminate the deferral that was introduced in the 2000 Budget (and subsequently enacted as subsections 7(8) to 7(16)) that permitted employees of public corporations (and public mutual fund trusts) to elect to defer the income inclusion associated with the exercise of a stock option until the year in which the underlying shares (or trust units) were sold (or the employee ceased to be a resident of Canada). The elimination of the deferral is effective with respect to all stock options exercised after Budget Date. Fortunately, the 2010 Budget does not appear to contain any measures which would bring to an end any existing deferral elections in respect of employee stock options exercised prior to Budget Date, but the implementing legislation will need to be closely reviewed on this point. Notably, the non-elective deferral in subsection 7(1.1) applicable to exercises of employee stock options granted by CCPCs will remain available.

From a stock option plan perspective, the fact that an employee will be subject to tax in the year of exercise may mean that, practically, an employee will sell at least a portion of the shares obtained on the stock option exercise to fund the tax liability. To this extent, the inclusion of a cashless exercise feature such as that described above may be beneficial.

Relief for Capital Losses

Lastly, the 2010 Budget proposes certain relieving measures for employees who have previously made elections pursuant to subsections 7(8) to 7(16) to defer the taxation on their stock option benefits in circumstances where the shares have declined in value from the date of exercise. In those circumstances, provided that the taxpayer disposes of the securities before 2015, the taxpayer can make an election in respect of the securities that will result in the taxpayer: (i) claiming a deduction under paragraph 110(1)(*d*) equal to the entire amount of the stock option benefit; (ii) including in income as a taxable capital gain an amount equal to 1/2 of the lesser of the stock option benefit originally computed and the capital loss from the disposition of the securities; and (iii) paying a special tax equal to the proceeds of disposition realized on the sale of the securities. In effect, the election should ensure that the tax liability on the stock option benefit does not exceed the proceeds of disposition of the securities taking into account tax relief from the use of capital losses against capital gains.

The relief, while welcome, is available only in limited circumstances, and notably, is not available where the employee has not made a subsection 7(8) election, including, for example, circumstances where the option exercised is a CCPC option and hence subject to deferred taxation pursuant to subsection 7(1.1). As such, employees who have exercised CCPC options will continue to suffer negative tax consequences where the shares decline in value from the date of exercise.

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[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 of the Act.

[3] As part of these rules, the 2010 Budget also proposes a clarifying amendment to make it clear that the disposition of rights under a stock option agreement by an employee to a non-arm's length person will give rise to an employee benefit at the time of the disposition.

[4]See, for example, CRA *Document* 9821967 (October 13, 1998) and *Document* 2M0333A, question 47 (October 30, 1992).

[5]Except in the case of options granted prior to Budget Date where the written option agreement includes a restriction on the disposition of acquired securities for a period of time after exercise of the option.

[6] On this point, subsection 227(1) provides that no action lies against an employer for deducting or withholding any sum of money in compliance or intended compliance with the Act; subsection 153(3) provides that an employee is deemed to have received the amount at the time the amount was deducted or withheld (even if the amount withheld was not required to be withheld – see, for example, *Suspended Power Lift*, [2008] 2 CTC 2072 (T.C.C.)); and subsection 227(13) provides a statutory discharge of liability to the employer vis-à-vis the employee to the extent amounts are remitted to the CRA on account of the employee.

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