

## Employee Stock Options

Employee stock options, awarded by a company to their employees as a form of incentive compensation, are an attractive tool to attract and retain talent in a very competitive marketplace.

Under the *Income Tax Act*, an employee can elect to exercise a stock option and receive the shares, or receive a cash payment (if the employer provides stock options with cash-out rights) equal to the in-the-money value of the exercised option (i.e. the difference between the exercise price paid by the employee and the fair market value of the shares at the time of exercise).

When an employee exercises the option and receives the shares, there is a deemed employment benefit equal to the in-the-money value of the exercised option. If certain conditions are met, the employee can claim a 50 percent deduction against the amount of the deemed employment benefit, effectively resulting in the stock option benefit being taxed at capital gains rates. The employer cannot claim a tax deduction.

Before the 2010 federal budget, the employer could claim a tax deduction when a cash payment equal to the in-the-money value of the exercised option was made to the employee (i.e. the employee exercised "cash-out" rights). In the appropriate circumstances, the employee could also claim a deduction.

Budget 2010 proposes that either the employee or the employer claim a deduction, but not both. This measure will immediately and retroactively apply to *all* options exercised (i.e. cash-out rights exercised) after March 4, 2010, regardless of the date the underlying option was granted. Employers that provide stock options with cash-out rights need to decide if they will forego the deduction of the cash-out right, whether to eliminate cash-out rights on outstanding options (through an amendment or conversion of an existing option), and whether to provide cash-out rights with new options. To preserve preferential tax treatment for the employee, an employer's election must be filed with the Canada Revenue Agency (CRA) by the employer, the employer is required to provide written evidence of the election to the employee, and the evidence of the election must be filed by the employee when he/she files his/her tax return claiming the 50 percent deduction.

As a result of these changes, the cash out alternative will make it more difficult for junior employees who participate in such plans. Further, the increased shareholder dilution may cause companies to abandon stock-option plans altogether or restrict their application to the most significant or senior employees.

With respect to existing awards, employers will have to consider the impact of the loss of the deferred tax asset for financial reporting purposes as well as the impact on numerous employees and stakeholders. The proposed modifications to the taxation of stock options will have a retroactive effect on these awards. As existing awards were issued in conformity with the long-standing position of the CRA with respect to the tax treatment of such awards, such a retroactive amendment is unacceptable and serves no clear policy objective other than generate additional tax revenue. Individual and business decisions are made on the basis of existing tax laws. Taxpayers require consistency, certainty and predictability so they may manage their affair intelligently.

Before the 2010 federal budget, an employee could defer paying tax on the stock option benefit relating to publicly traded shares (up to an annual vesting limit of \$100,000), provided certain conditions were met, until the underlying shares were sold. Budget 2010 eliminates the tax deferral election effective March 4, 2010. Unless required to hold a certain number of shares under an employment contract or equity investment policy of the company, employees may end up selling their shares immediately after exercising their options in order to pay for the tax liability, working against the objective of employers to promote minimum or target share ownership. Some employees may be unable to do so where the shares are thinly traded.

The Budget proposes to provide relief to individuals who took advantage of the deferral election and find themselves in a situation where the proceeds from selling their shares are insufficient to pay the tax on the stock option employment benefit (the allowable capital loss arising at the time of disposition cannot be used to offset the taxable employment benefit). An employee will be able to elect to pay a special tax

equal to the full proceeds of the disposition (two-thirds of the proceeds if the taxpayer is a Quebec resident). This is to ensure that the tax liability on a deferred stock option benefit does not exceed the fair market value of the shares being sold. The special election is intended to apply to sales of optioned shares before 2015. For shares sold before 2010, the employee will be required to make the election on, or before their filing due-date for the 2010 taxation year (generally April 30, 2011).

To ensure the government collects taxes when options are exercised, employers will be required to withhold tax at source and remit tax. The new rules will apply after 2010. Employers will need to withhold tax from the employee's remuneration to the same extent as if the amount of the benefit had been paid to the employee in money as a bonus. The amount of withholding may be reduced to the extent the 50 percent deduction is available. The upfront payment may cause cash-flow problems and hardship for an employee who is required to come up with both the exercise price and the tax. Those employees who have options in publicly traded shares may be able to sell their shares immediately upon exercise to fund the tax withholding, unless they are subject to lock-ups or blackouts. It is unclear what would happen if the amount of the employee's cash remuneration is not sufficient to fund the withholding obligation. In the past, where full withholding and remittance would be problematic, the CRA provided administrative relief.

Relief from withholding and remittance is provided under the 2010 federal budget proposals where the employee exercises options granted before 2011 if the stock option agreement was entered into before 4 p.m. EST on March 4, 2010 *and* the employee is subject to a written condition that restricts his or her ability to dispose of the securities acquired upon exercise for a period of time after exercise. Withholding will not be required where the employee stock option is granted by a Canadian-controlled private corporation (CCPC) because the taxable benefit is not realized at the time of exercise but when the shares acquired on exercise are sold.

The administrative complexities forced upon employees to try to comply with the rules prescribing withholding taxes on the exercise of stock options are of significant concern.

In general, stock options may no longer be as attractive an incentive compensation for either employees or employers. Companies may have few alternatives for mid-term incentives, as cash settled restricted stock units have a maximum term of three years, and deferred share units are intended to be paid at the end of a career.

### **Recommendations**

That the federal government:

1. Not proceed with the retroactive nature of the change to programs with "cash-out" rights (i.e. the budget proposals with respect to "cash-out rights" should not apply to any agreement entered into before 4 p.m. on March 4, 2010).
2. Exempt from withholding tax plans where employees are not able to sell shares (either because of restrictions imposed by the employer, or due to a limited market for the shares).