

## **Taxation Measures in the 2010 Federal Budget – Employee Stock Options**

The federal budget introduced by the Minister of Finance (Canada) on March 4, 2010 contain proposals to change certain rules in the *Income Tax Act* (Canada) relating to the taxation of employee stock options.

### ***Stock Option Cash Outs***

Upon the exercise or disposition of an employee stock option, a Canadian resident employee (which includes a director) is generally required to include in income an employment benefit. Where certain conditions are met, the employee is entitled to a deduction equal to one-half of such employment benefit (the "One-Half Deduction") thereby resulting in an effective rate of tax that is equivalent to capital gain rates.

Employers are generally prohibited from deducting any amount on the issuance of shares on the exercise by employees of a stock option. Where, however, the employee is given the right to dispose of his or her stock option in exchange for a cash payment from the employer equal to the "in the money" value of the stock option, the employer is generally entitled to deduct the amount of the payment, and the employee is also entitled to claim the One-Half Deduction. The Budget proposes that where an employer makes a cash payment on the cash-out of an employee's stock options, the employee will no longer be entitled to claim the One-Half Deduction (assuming that the employee otherwise qualifies), unless the employer makes an election to forgo a deduction in respect of the cash-out payment. This proposal is effective for stock option transactions occurring after 4:00 p.m. (EST) on March 4, 2010.

This Budget proposal will not affect employees who exercise stock options and acquire the shares. In such case, the One-Half Deduction would continue to be available.

### ***Elimination of Deferral Election***

Where an employee exercises a stock option to acquire shares of a corporation (other than a Canadian-controlled private corporation with whom the employee deals at arm's length), the employee is generally taxed on the employment benefit at the time of such exercise. In certain circumstances, an employee who exercises the stock option to acquire shares listed on a stock exchange may jointly elect with his or her employer to defer recognition of the employment benefit from the time of exercise to the time the share is disposed of.

The Budget papers note that when an employee makes the deferral election, the employee may not be able to meet his or her tax obligation where there is a subsequent decrease in the value of the shares. For this reason, the Budget proposes to remove the ability to make the deferral election in respect of stock options issued after 4:00 p.m. (EST) on March 4, 2010. This change will have the practical incentive of encouraging employees to sell some or all of the shares acquired on the exercise of a stock option in order to have sufficient funds to pay the resulting tax liability.

For employees who previously made a tax deferral election, the Budget proposes special elective tax relief which is intended to provide that the tax liability on the deferred stock option benefit does not exceed the proceeds of disposition of the shares acquired on the exercise of the stock options.

### ***Tax Withholding/Remittance Obligations***

It was the long-standing administrative position of the Canada Revenue Agency not to require the employer to withhold and remit tax in respect of an employee who exercised a stock option and acquired the underlying shares where the withholding would cause undue hardship to the employee. The budget proposes that amounts must be withheld and remitted by employers (other than in respect of stock options issued by Canadian-controlled private corporations) in respect of a stock option benefit to the same extent as if the amount of the benefit had been paid to the employee as a cash bonus. The Budget proposals also confirm that if the One-Half Deduction is available to the employee, then for purposes of determining the employer's remittance obligation, the amount of the benefit may be reduced by the One-Half Deduction. These new withholding and remittance rules apply in respect of securities acquired by employees after 2010 and will not apply in respect of stock options granted prior to 2011 pursuant to a written agreement entered into before 4:00 p.m. (EST) on March 4, 2010 and where the agreement included restrictions on the employee's ability to dispose of the underlying shares.

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