

Tax Law

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The Party's Over - Revisiting Compensation Plans Post-Budget

The 2010 Federal Budget (the "Budget") significantly alters the manner in which certain forms of equity-based compensation arrangements will be taxed. Employers that offer stock-based compensation to their employees may have to examine, re-evaluate and possibly amend their plans in light of these proposed changes. For the most part, the changes eliminate certain tax advantages that were previously available with respect to the design of stock option plans. While some of the changes will, if enacted, be effective as of March 4, 2010, other proposals will only be implemented in 2011.

An End to "Having Your Cake and Eating It Too" - Cashing-Out Stock Options

The most significant proposed change relates to the cash-out right contained in many option plans. Currently, if an employee exercises a stock option and receives stock, no deduction is available to the employer with respect to the issuance of the stock. However, if the stock option plan provides that employees can elect to receive the "in the money amount" on their options in cash (instead of paying the exercise price and receiving shares), a deduction may be available to the employer with respect to that cash payment. Additionally, if an existing option plan is structured such that the employee is taxed on the option benefit at an effective capital gains rate, electing to receive cash in lieu of stock does not affect this favourable tax treatment. The combined beneficial effect of a deduction to an employer, coupled with no prejudice to the employee's tax treatment, resulted in a cash-out right being a feature of many existing stock option plans.

The Budget proposals will curtail this tax treatment. Under the new rules, if an employee is to be taxed at

the effective capital gains rate, then the employer must file an election with the Canada Revenue Agency stating that the employer will not deduct any amount paid to the employee with respect to the disposition of their rights under the stock option. The process will involve (i) the employer providing the employee with a statement that the election has been made; and (ii) the employee, in turn, filing this statement with his or her tax return for the year in which the stock option benefit is realized. If the statement is not filed, the stock option benefit will be taxed as ordinary employment income.

In effect, employers are given a choice - if they want to preserve favourable income tax treatment for their employees, they must affirmatively elect to forgo the deduction. Interestingly, the Department of Finance has indicated that the election can be made on an employee-by-employee basis, and does not have to apply to all employees under an option plan. Whether or not an employer will choose to make elections in certain circumstances and not in others remains to be seen.

Because employees accustomed to receiving favourable tax treatment for options may not be aware of this, the Budget proposals also raise questions as to how employers should communicate these changes to employees (particularly if the employer does not intend to forego the deduction).

This change is effective for all stock options that are cashed-out after 4:00 pm on March 4, 2010, regardless of when the stock option was issued. This lack of grandfathering will mean that employers and employees will have to consider the implications of utilizing a cash-out right contained in existing option plans. As the use of stock options as a form of compensation is typically predicated on the preferential tax treatment it affords employees, this Budget proposal will likely cause employers to reconsider the utility of including cash-out rights in future option plans.

No Free Lunch - Mandatory Tax Withholding

Employers have always been technically required to withhold tax in respect of equity-based compensation. However, until now, this withholding obligation could, in many circumstances, be avoided for Canadian resi-

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dent employees if the employer issued securities to the employee. The Budget proposals explicitly require employers to withhold and remit tax in respect of most stock option benefits (taking into account any stock option benefit deduction that is available to the employee). For employees of public corporations, this benefit is realized at the time the stock option is exercised. As a practical manner, procedures will have to be developed in order to comply with this requirement, including, for example, withholding sufficient securities to fund the withholding obligation. At the very least, it will likely mean that some of the securities an employee would otherwise receive will have to be liquidated by the employer to fund the withholding obligation. This change is arguably most significant for employees of private corporations that are not Canadian-controlled private corporations, as withholding is required at the time of exercise and a readily available market for the shares may not exist.

Existing plans may not expressly contain this ability to withhold and therefore plans should be reviewed now to determine if amendments are necessary. Even if the plans refer to withholding obligations, they typically do not authorize the employer to liquidate securities to satisfy the obligation and may therefore require review and amendment.

The Budget proposals relating to mandatory withholding are not intended to be effective until 2011, in part to allow appropriate payroll mechanisms to be put in place to deal with this situation. In circumstances where option agreements contain a restriction on the ability to dispose of shares, options granted before 2011 may be grandfathered from this requirement.

Food For Thought - Implications of the Proposals

The Budget proposals will require action on the part of many employers, both in terms of existing plans and future plans:

- For those employers whose existing option plans contain cash-out rights, decisions will need to be made as to (i) whether or not to make an election with respect to the exercise of cash-out rights after 4:00 pm on March 4, 2010; and (ii) if no election is to be made, as to whether and how this is to be communicated to plan participants.
- For employers who are considering implementing new plans or amending existing ones, a decision must be taken as to whether to include a cash-out right as a feature. Consideration will also need to be given as to whether plans should expressly deal with the obligation to make the election.
- Decisions will be required regarding the changes necessary to comply with the mandatory withholding obligations, including potential changes to existing plans to facilitate compliance after 2010, as well as changes to payroll procedures.

If you would like our assistance in making any of these decisions, or if you have any questions regarding these changes, please feel free to contact any member of our Tax Group:

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