

New Tax Rules on Stock Options Result in Immediate Costs

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The 2010 Federal Budget included significant changes to the tax rules on public company stock options that are exercised by employees, including directors, after March 4, 2010. Payroll withholding payments will be required in 2011 and the value of stock options must be treated essentially as a cash bonus when options are exercised.

In summary, there are three main tax changes to the taxation of employee stock options:

- 1) Elimination of the tax deferral of stock option benefits
- 2) Employer cash withholding on taxable stock option benefits
- 3) Cash-out option deductions

Elimination of the Tax Deferral of Stock Option Benefits

Employees are no longer able to defer the taxable benefit on exercising options. The value of the options exercised is the fair value of the shares received less the amount paid to acquire and exercise the options. The value of the options exercised after March 4, 2010 is included in the individual's tax return as taxable income. Most individuals are entitled to a stock option deduction equal to 50% of the amount included in income, resulting in a tax at the capital gains rate if: (a) the employee exercises their options by acquiring their employer's shares or (b) the employer elects not to claim a deduction for the cash-out payment for the employee's disposition of rights under the agreement.

If a stock option benefit has been deferred prior to March 4, 2010 and the value of the stock has decreased significantly, affected individuals will be eligible for special relief by a tax reduction that reflects the actual amount received on the sale of devalued stock.

Employer Cash Withholding on Taxable Stock Option Benefits

Effective January 1, 2011, when an individual exercises public company stock options the employer will be required to remit withholdings on the amount of the taxable stock option benefit (considering any stock option deduction) in the same manner as if the amount of the benefit had been paid as a cash bonus. A practical difficulty arises as the withholding payment is based on a non-cash gain in value on the exercise of options and the withholding must be paid in cash. The cash withholding may be a large amount and the company needs to consider whether the individual should personally pay the employer the amount from either personal savings or from cash realized on the sale of the shares after the stock option is exercised.



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A grandfathering provision exists and payroll withholdings are not required on options granted before 2011 pursuant to a written agreement entered into before March 4, 2010 that includes a condition restricting the sale of shares acquired through the exercise of the options.

For more information on taxable stock option benefits refer to CRA's webpage at the link: <http://www.cra-arc.gc.ca/tx/bsnss/tpcs/pyrll/bnfts/fnncl/srty/menu-eng.html>

In addition, it's important to note that there are no changes to the tax treatment in options granted to consultants, who continue to include the value of options received in their taxable income.

Cash-out Option Deductions

Certain stock option arrangements allow employees the option to receive cash payouts equal to the option value in lieu of receiving shares. In the past, companies were permitted a corresponding tax deduction for these cash-out rights, and provided certain conditions were met, the employee could claim a stock option deduction equal to 50% of the taxable benefit for the shares. Now the employee is taxed at source and is denied the 50% stock option deduction unless the company files an election declaring the company itself will make no deduction for the cash payout.

Rules on Options Exercised Before March 4, 2010

Prior to March 4, 2010 eligible employees could elect to defer the taxable benefit on a stock option exercise (subject to a \$100,000 annual benefit limit) until the underlying shares were sold or deemed to be sold. The employee's election is made by filing Form T1212, Statement of Deferred Security Options Benefits, with their income tax return for each year they have a balance of deferred stock option benefits outstanding.

Companies would accept the employee election to defer the benefit and report the amount of the deferred benefit in the "Other Information" area under code 53 at the bottom of the employee's T4 slip.

Where to Go for Help

As you can see, these new tax rules on stock options have a significant impact on many public companies. We encourage you to call or email your Manning Elliott advisor, or one of the contacts listed below, to navigate these complex and potentially costly waters.

Joseph Bonvillain CA, Partner – (604) 714-3643 – Email: joseph@manningelliott.com

Steve Reed CA, Tax Partner – (604) 714-3616 – Email: sreed@manningelliott.com

Steve Youn CGA, Tax Manager – (604) 895-8576 – Email: syoun@manningelliott.com

