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Canada's 2010 Budget Affects Options and Stock Appreciation Rights

By [Christina Medland](#)

Canada's 2010 Budget released March 4, 2010 makes several significant changes to the taxation of options and stock appreciation rights (SARs). In general, the new regime takes effect after 4:00 p.m. (EST) on March 4, 2010.

First, the 2010 Budget eliminated the limited deferral that allowed an optionholder to defer tax on the exercise of an option to acquire publicly listed shares until the year in which the shares were sold (subject to an annual limit of \$100,000); so options are now taxed at the time of exercise. The deferral for options to acquire shares of Canadian-controlled private corporations (CCPCs) was retained.

The 2010 Budget provides relief for employees who made the \$100,000 deferral election and experienced financial hardship because of a decline in the value of the optioned shares: the budget provides a new election that limits the tax liability to the value of the optioned shares.

Second, the Canada Revenue Agency (CRA) has eliminated the administrative policy that permitted (i) an optionholder to elect to receive the difference between the exercise price and fair market value of the shares (the "in the money" amount) in cash (a SAR) and to be effectively taxed at capital gains rates; and (ii) the employer to claim a deduction for the amount paid. Now, optionholders will be eligible for capital gains rates taxes only if they (i) exercise options by acquiring shares; or (ii) exercise a SAR and the employer makes an election to forgo the deduction for the cash payment it made. This change is not particularly surprising, because the previous situation was anomalous from a tax policy perspective.

Third, the 2010 Budget clarifies that employers are required to withhold tax on the exercise of an option (other than in respect of a CCPC). In the past, withholdings had to be made against other cash payments and where this would significantly reduce an employee's take home pay and create financial hardship, employers relied on an administrative concession to reduce or eliminate withholdings. The 2010 Budget does not address the availability of this administrative concession. Therefore, employers relying on "financial hardship" to reduce withholdings should seek a formal waiver from the CRA.

Effect of the Changes on Existing Option and SAR Plans

In order to meet the CRA's previous administrative policy to effectively get capital gains tax rates on SARs, plans were drafted so the employee had the right to exercise the option and acquire shares. Under the new regime, employees will now always elect to exercise options, rather than SARs, unless the employer commits to elect to forgo the deduction. The only exception to this may be in unusual circumstances in which

To discuss these issues, please contact the author.

For media calls, please contact [Stuart Wood](#), Chief Marketing Officer, 416.865.8205.

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there is a requirement to hold the option shares for a lengthy period. The effect of the tax changes is that some of the good governance practices becoming associated with option grants (e.g., a hold period after exercise or during employment for the optioned shares) will likely be eliminated.

Companies that wish to encourage employees to exercise SARs (to avoid dilution, particularly if they have a plan that allows the shares' underlying options cancelled on the exercise of the tandem to be added back to the reserve) should make the commitment to forgo the deduction.

Given the lack of advantage of SARs and the potentially adverse accounting treatment, we expect that employers will consider whether they should retain the ability to grant SARs. Option and SAR plans that do not provide for the employer to sell or withhold shares on the exercise of an option, to provide for withholding taxes, should be amended to specifically permit this. 