The rules change for employee stock option

Many employees, especially at the senior management level, are compensated in part through the right to acquire shares of the employer company, usually at a reduced cost or on favourable terms. The appeal of stock options as a form of compensation is increased by the favourable tax treatment accorded such options.

Following changes proposed in this year's federal budget, some of the benefits which accompanied the receipt or exercise of stock options have been scaled back, for both employers and employees.

The new rules will effectively deny the "double deduction" which may currently be claimed where employees "cash out" a stock option. As outlined by the Department of Finance in its explanatory notes to the budget, where an employee acquires shares of the employer company pursuant to a stock option agreement, that employee receives a taxable employment benefit equal to the difference between the fair market value of the shares at the time they are acquired and the price actually paid by the employee. So, if an employee acquires shares which are worth $100 on the open market but pays only $40 for those shares, he or she is considered to have received a taxable employment benefit of $60. However, under certain conditions, the employee is entitled to claim a deduction on his or her tax return for the year equal to one-half of that taxable benefit amount – in this case, $30 – but no deduction can be claimed by the employer with respect to the issuance of the shares under the stock option. The rules respecting the taxation of stock options which are exercised in this way are unchanged.

However, in some circumstances, employees choose, rather than exercising their option, to "cash-out" – that is, to dispose of their stock option right in exchange for a cash payment from the employer. In that case, the deduction remains available to the employee, but the employer can also claim a deduction for the amount of the cash payment. The Department of Finance views such a result as inconsistent with the policy objectives of the stock option deduction rules. For stock option dispositions which occur after 4:00 p.m. on March 4, the stock option deduction will be available to employees only where they exercise their option to acquire shares of the employer, or where, if there is a “cash-out”, the employer agrees to forgo the deduction for the cash payment made. In other words, only one deduction, by either the employer or the employee, will be permitted where a stock option is exercised or cashed out.

The second major change to affect the taxation of stock options will require employees to remit tax payable on benefits received in relation to stock options at the time those benefits are received. Under pre-budget rules, where employees of publicly traded companies received such a taxable benefit, they could elect to defer the recognition of the employment benefit for tax purposes until the shares were sold, which could be years later. The proposed budget changes will repeal that tax deferral election, effective for stock options exercised after 4:00 p.m on March 4.

In addition, the withholding tax rules will be amended to provide that tax payable in respect of the stock option benefit is to be withheld from the employee’s pay and remitted by the employer to the government at the time the shares are issued. Because of the changes to compensation arrangements and payroll systems which this measure will require, the change in the withholding and remittance requirements will be deferred to apply to benefits arising on the issuance of securities after 2010.

Finally, the proposed changes to the stock option benefits rules did include one relieving measure. The significant downturns in the stock market during the last decade have meant that some taxpayers who took advantage of the tax deferral election on stock options later faced a tax bill which exceeded the value of the underlying shares when those shares were sold. To address this, the budget proposals include a measure to introduce a special elective tax treatment for such taxpayers. That treatment will, in effect, ensure that the deferred tax liability on a stock option benefit is never greater than the amount for which the underlying shares are sold. Where that sale took place before 2010, affected individuals will need to make the election on or before the filing due date for their 2010 returns, which would in most cases be April 30, 2011. Where no disposition took place before 2010, those who wish to make the election must dispose of the shares before 2015 and then make the election on or before the filing due date for the year in which the disposition takes place.