A Director's Guide to
EXECUTIVE COMPENSATION

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# Stock Options

## Impact of the 2010 Budget

Stock options received significant attention in the last decade from various stakeholders. Initially, the attention focused on the excessive payouts to executives as the financial markets soared. With the financial market meltdown, the attention suddenly shifted to whether to address the vast amounts of underwater options held by executives. Now, the federal government has turned its attention to the tax treatment of stock options in its March 4, 2010 budget (Budget).[1] The Budget proposes to eliminate certain tax benefits associated with stock options. Yet, even after eliminating the preferential tax treatment, stock options can be an appropriate form of compensation when properly designed and awarded.

This newsletter reviews the key changes proposed in the Budget and in the Quebec budget, the terms of stock option plans that should be reviewed in light of these budgets and, as usual, outlines recent securities updates.

## Pre-Budget Tax Regime

### Stock Option Deduction

The grant to an executive of a stock option generally does not give rise to a taxable event to the executive. This assumes the stock option was granted with an exercise price at least equal to the fair market value (FMV) of the share underlying the grant. This is consistent with the requirements of the Toronto Stock Exchange applicable to listed issuers.[2]

Assuming the stock option was granted by a public company with an exercise price at least equal to the FMV of the underlying share, the executive would generally be taxed when exercising the stock option to acquire the underlying share. The amount by which the share price at the time of exercise exceeds the exercise price of the stock option is the amount that is taxable and, commonly, is referred to as the "in-the-money" amount.

The *Income Tax Act* (Canada) *(ITA)* generally provides for an income deduction of 50 per cent (only 25 per cent in Quebec) of the in-the-money amount, referred to as the "stock option deduction", provided certain conditions are met.[3] The impact of the stock option deduction is that the stock option is effectively taxed at capital gains rates. This effectively puts the executive in the same position as though the executive had acquired stock at the time of the

**These quarterly newsletters provide practical advice and current legal comments on executive compensation and compensation governance and disclosure. These newsletters will be of interest to directors, executives, lawyers and human resources professionals.**

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## From the Editor

This newsletter comments on the aspects of the 2010 federal budget that impact the tax treatment of stock options. I am delighted to welcome comments on the 2010 Quebec budget implications from Stephan Scott Trudeau, formerly VP and General Counsel at ABB Inc. and now Counsel at Davis LLP, a leading full service law firm with offices across Canada and in Japan.

— *Nadine Côté LL.B.*

grant of the stock option and sold it upon exercising the stock option.

### Share Appreciation Rights

A share appreciation right (SAR) is a right to receive the in-the-money amount on exercising the SAR, in the form of cash or shares, depending on the terms of the SAR. Exercising SARs, unlike stock options, does not require the holder to use his or her money to buy the share and then sell it in order to receive the in-the-money amount, in addition to paying transaction fees.

SARS can be granted on a stand-alone basis or in tandem with a stock option, which affects their tax treatment. Cash-settled stand-alone SARs do not receive any beneficial tax treatment. On exercise, the in-the-money amount is fully taxable as employment income without any deduction.

Cash-settled SARs granted in tandem with stock options under the pre-Budget tax regime received the same beneficial tax treatment as stock options – namely, the benefit of the stock option deduction. As such, a cash-settled tandem SAR achieved the best of both worlds: the executive received cash compensation that was effectively taxed at capital gains rates; and, the organization was able to deduct the expense. As described below, the Budget proposes to change this tax structure.

## Stats on Deduction Claims

Approximately 78,000 Canadian tax payers took advantage of the stock option deduction in 2007, claiming an average of $53,000 and a total aggregate value of $4,130 million. The amounts they claimed can be broken down further as follows:

- About 32,000 (41%) claimants earned less than $100,000 and the amount they claimed was only 2% of the aggregate value of the deduction
- About 38,000 (48%) claimants earned $100,000 to $500,000 and the amount they claimed was 22% of the aggregate value of the deduction
- About 8,000 (10%) claimants earned more than $500,000 and the amount they claimed was 75% of the aggregate value of the deduction, their average amount being $393,000.[4]

## Budget Impact

### SARs Double Deduction Eliminated

The Budget proposes to eliminate the ability of both the employer and the employee to claim a deduction under the *ITA* upon exercising cash-settled SARs granted in tandem with stock options. Pursuant to the Budget, only the employer can claim the deduction for the cash disbursement, unless the employer makes an election in a prescribed form to waive it. The employee would be eligible to claim the stock option deduction if: the employer makes an election in a prescribed form not to take its deduction; the employer provides a copy of the election to the employee; and, the employee files the election in the year the employee claims the stock option deduction. These measures would apply to dispositions of stock options after 4:00 p.m. Eastern Standard Time on March 4, 2010.

### Income Deferral Eliminated

Pursuant to the federal budget in 2000, an employee of a public company could elect to defer the income inclusion of the in-the-money amount, from the year of exercise, to the year the shares were sold, to a maximum of $100,000. The Budget proposes to eliminate this deferral for stock options exercised after 4:00 p.m. Eastern Standard Time on March 4, 2010. The Budget does not affect the deferral of the stock option benefit for employees of Canadian controlled private companies (CCPCs).[5]

### Special Relief for Historical Tax Deferrals

The financial market meltdown over the last couple of years significantly depressed the prices of the common share of many companies. This negatively impacted many stock option holders who exercised their stock options before the meltdown and elected to defer their tax liability to the date of disposition of the shares. Some of those who have had to sell their shares while prices are depressed have incurred tax liabilities greater than their proceeds on selling the shares. The Budget proposes special tax relief in these situations. Essentially, the special tax relief would limit the tax liability to the proceeds of the sale (two-thirds of the proceeds for residents of Quebec), taking into account the tax benefit of the capital loss, provided the shares are sold before 2015.

### Withholding Obligation Clarified

The Budget proposes to clarify an employer's obligation to remit taxes on the exercise of stock options, even when stock options are exercised and the shares acquired are held, rather than sold. The Budget clarifies that taxes must be remitted in respect of the in-the-money amount as if the benefit had been paid to the employee as a cash bonus. If the stock option deduction is available to the employee, the deduction can be taken into consideration in determining the amount of taxes to be remitted on the exercise of the stock option. The remittance requirement applies to benefits arising on the issuance of securities after 2010. There is a limited exception to the employer's remittance obligation for stock options granted before 2011 if there was a pre-existing agreement in writing entered into before 4:00 p.m. Eastern Standard Time on March 4, 2010, which restricted the employee from disposing of the shares for a period of time after the acquisition.

## Practical Considerations

Despite the restrictions proposed in the new Budget, stock options continue to be an appropriate form of compensation when properly instituted and awarded. Stock options are one of the rare forms of compensation that can be awarded to executives on a tax effective basis, if implemented to benefit from the stock option deduction. Also, stock options allow executives to benefit from growth in an organization only from the date of award; not its historical growth prior to the date of the award, the value of which the executive may not have contributed to, particularly if he or she only recently joined the organization. Given that stock options can still benefit companies and executives, they can continue to form part of an executive's compensation package. However, given the changes proposed in the Budget, companies should review their stock option plans, awards and communications to:

- Assess if the company committed to ensuring the executive would benefit from the stock option deduction; and, if so, assess the cost to the company of

## Québec Adopts Federal Budget Harmonization Measures

**By Stephan Scott Trudeau, Davis LLP**

On March 30, 2010, Québec Finance Minister Raymond Bachand tabled the 2010-2011 provincial budget (the "Québec Budget").[6] The Québec Budget noted that the province would adopt measures similar to those taken by the federal government as announced in its Budget, particularly those regarding the tax treatment of stock options.

The Québec Budget therefore eliminates the double deduction associated with a cash-settled tandem SAR. Under this measure, the employee deduction of 25% of the in-the-money amount can now be claimed by the employee only when the employee actually acquires securities from the employer, or if the employer makes an election to forgo the deduction for the cash payment pursuant to a cash-settled tandem SAR.

The Québec Budget also eliminates the existing tax deferral election of the in-the-money amount made available to employees of publicly-traded companies. Much like the Budget, the Québec Budget does not affect the tax deferral of the in-the-money amount by employees of CCPCs or mutual fund trusts.

Finally, the Québec Budget provides tax relief to those individuals who exercised their stock options prior to the financial markets meltdown and elected to defer tax liability to the date of disposition. Subject to certain conditions, and when the value of the optioned securities is less than the tax that was deferred, employees can be eligible for certain tax benefits.

*Thanks for the contribution of Stephan Scott Trudeau, Counsel at Davis LLP, specializing in Corporate and Commercial Law, including matters related to the duties of directors and officers of corporations. Davis LLP is a leading full-service law firm providing comprehensive legal services to clients through offices across Canada and in Japan.*

the foregone tax deduction

- Assess if the company has the authority to override an executive's election to receive a cash-settled SAR
- Assess if the company needs to clarify or comment on the elimination of the election to defer stock option benefit
- Assess which stock options, if any, will be granted in the future with cash-settled tandem SARs
- Assess if the company maintained its right to withhold income tax on the exercise of stock options and assess how the withholding will be handled if stock options are exercised and the stock is held

## Securities Updates

### OSC

On August 17, 2010, the Ontario Securities Commission released its annual report for 2010. The following is noteworthy.

- There were 16 proceedings involving 32 respondents, down from 21 and 46, respectively in the prior year
- There were 18 cease trade orders and 18 director and officer bans, down from 23 and 29, respectively in the prior year
- Penalties, disgorgement orders and settlement amounts totalled approximately \$36 million, down from approximately \$86 million in the prior year, of which \$68 million was the repayment by three individuals to Research In Motion Ltd. pursuant to a settlement with the OSC.[7]

### CSA

On April 30, 2010, the Canadian Securities Regulators (CSA) released CSA Staff Notice 55-315 - *Frequently Asked Questions about National Instrument 55-104 Insider Reporting Requirements and Exemptions* to assist reporting insiders with respect to the new regime and to promote consistency in electronic filings on the System for Electronic Disclosure by Insiders (SEDI).[8]

On June 11, 2010, the CSA released:

- CSA Staff Notice 55-312 - *Insider Reporting Guidelines for Certain Derivative Transactions (Equity Monetization (Revised)*, which revised the notice first published on February 27, 2004
- CSA Staff Notice 55-316 *Questions and Answers on Insider Reporting and the System for Electronic Disclosure by Insiders (SEDI)*, which replaces CSA Staff Notice 55-308 - *Questions on Insider Reporting* and CSA Staff Notice 55-310 - *Questions and Answers on the System for Electronic Disclosure by Insiders (SEDI)*[9]

On July 9, 2010, the CSA announced the Results of Continuous Disclosure Reviews for Fiscal 2010. Of the 4,200 reporting issuers, other than investment funds, subject to regular reviews, 1,351 were reviewed. This represents a 23 per cent increase from fiscal 2009, mainly due to the completion of the International Financial Reporting Standards (IFRS) transition disclosure reviews. The results of this year's reviews are as follows:

- 43 per cent were required to enhance future filings
- 9 per cent were proactively alerted to specific areas where disclosure enhancements should be considered
- 16 per cent were required to amend or re-file certain documents, some of which included the Form 51-102F6 *Statement of Executive Compensation*
- 4 per cent had critical deficiencies and may be added to the default list, issued a cease trade order or referred to Enforcement.
- 28 per cent required no changes.[10]



[1] Department of Finance Canada, Budget 2010: Leading the Way on Jobs and Growth; online: http://www.budget.gc.ca/2010/plan/toc-tdm-eng.html (Budget).

[2] Toronto Stock Exchange, TSX Company Manual (Toronto: CCH, 2006) s. 613.

[3] *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (*ITA*) s. 110(1)(d). Special rules apply to Canadian controlled private companies.

[4] Budget, *supra* note 1 at Annex 5 p. 353.

[5] Under the *ITA*, when a CCPC, as defined therein, agrees to sell or issue common shares to an executive, the benefit to be included in income is generally delayed until the year in which the executive disposes of the shares.

[6] Finances Québec, Budget 2010-1011: Choices for the Future; online: http://www.budget.finances.gouv. qc.ca/ Budget/2010-2011/en/documents/BudgetPlan.pdf.

[7] Ontario Securities Commission 2010 Annual Report, online: http://www.osc.gov.on.ca/static/_/Annual Reports/2010/index.html.

[8] CSA Staff Notice 55-315 - *Frequently Asked Questions about National Instrument 55-104 Insider Reporting Requirements and Exemption* (2010) 33 O.S.C.B. 3910.

[9] CSA Staff Notice 55-312 - *Insider Reporting Guidelines for Certain Derivative Transactions (Equity Monetization (Revised)* (2010) 33 O.S.C.B. 5205; CSA Staff Notice 55-316 *Questions and Answers on Insider Reporting and the System for Electronic Disclosure by Insiders (SEDI)*(2010) 33 O.S.C.B. 5217.

[10] Canadian Securities Administrators Announce Results of Continuous Disclosure Reviews for Fiscal 2010, online: http://www.securities-administrators.ca/aboutcsa.aspx?id=914.