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The 2010 Federal Budget proposed several important amendments to the employee stock option rules under the *Income Tax Act* (Canada). Included in these revisions are:

(a) provisions negatively affecting the tax consequences of "cashless exercise" arrangements under stock option plans;

(b) the repeal of provisions that previously allowed recipients of public company stock options to defer the tax consequences of their stock option grant until the disposition of the optioned shares; and

(c) the explicit imposition of requirements on companies that grant stock options to withhold and remit amounts to the Canada Revenue Agency when their option-holders exercise stock options.

For more information on the above-noted changes, please see the attached tax note which has been provided to us by Thorsteinssons LLP, Canada's largest law firm specializing solely in tax matters. These changes will require most public companies to amend their stock option plans.

Feel free to contact any of the following partners at Axium in order to discuss amending your stock option plan in relation to the foregoing changes, or if you have any other securities-law related questions:

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Please contact Ted Sutcliffe of Thorsteinssons to discuss any tax planning matters related to the foregoing change, or if you have any tax related questions:

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TAX NOTE

Employee Stock Options: 2010 Federal Budget Amendments

Ted Sutcliffe and Daniel Bellefontaine

THORSTEINSSONS LLP

The 2010 Federal Budget proposed several important amendments to the employee stock option rules under the *Income Tax Act* (Canada) (the "Act") which are to have effect as of March 4, 2010. Among these changes, the following three are of particular importance to public companies:

1. restricted deductions for stock option cash-out payments;
2. the repeal of the tax deferral for options on listed stock; and
3. the clarification of certain withholding requirements.

1. Restricted Deductions on Stock Option Cash-outs

Many employee stock option plans have cash-out provisions (often referred to as a "cashless exercise") under which the employee has the right to choose cash, instead of shares of the employer, on exercise. Typically, the cash payment available to the employee reflects the "in the money" amount of the employee stock option. An employee stock option will result in the employee realizing a taxable employment benefit, generally in the year the option is exercised or disposed of.

The amount of the benefit is generally equal to the difference between the fair market value of the share at the time of acquisition and the cost to the employee of acquiring it (ie. the exercise price). Under current rules, the employee is generally entitled to deduct 50% of the benefit associated with exercising the option. At the same time, if the employee receives a cash-out payment under the option, the current rules permit the employer to deduct the cash-out payment. In short, the current rules permit two deductions (one to the employee and one to the employer) in respect of the same amount. This favourable tax treatment has made cash-out stock option plans attractive to employers.

Under the new rules, the employee will be prohibited from accessing the 50% deduction on the exercise of a cash-out right unless the employer elects in prescribed form to forego its deduction of any amount in respect of the cash-out, other than certain expenses associated with hedging the financial risk of the stock option plan. As a practical matter then, if the employer makes this election, so as to preserve the attractive pre-amendment tax treatment for employees, the incentive plan will become more expensive for employers to maintain due to the non-deductibility of cash out payments.

Employers having stock option plans with cash-out features need to be aware of this change and may wish to consider whether changes to the plan would be appropriate.

2. Repeal of the Tax Deferral Election

Under current rules, employees who exercised options on listed stock could elect to defer tax on the employment benefit until they disposed of the optioned share (subject to certain limits). This deferral election is repealed for all options exercised after March 4, 2010. A deferral continues to be available for employee options for Canadian-controlled private corporation ("CCPC") shares.

Although the deferral has been eliminated, the amendments provide relieving rules for employees who made a deferral election prior to March 4, 2010. Where the employee makes an election for relief, they will pay a special tax equal to the proceeds of disposition of any optioned share sold or otherwise disposed of during the year (for Quebec residents, the tax is 2/3 this amount) instead of paying the tax arising from the option exercise. This special relief is useful in circumstances where the value of an employee's optioned shares has fallen and are sold for less than the amount of tax owing from the exercise of the option. The provisions also contain a mechanism for adjusting the capital loss on the disposition of the optioned share.

In order to qualify for the special relief, the employee must have made a deferral election in respect of an option and disposed of the optioned share before 2015. The election for special relief must be made in the year of the optioned share's disposition or, if the disposition occurred before 2010, by the employee's filing due date for 2010 (ie. by April 30, 2010).

3. Clarification of Withholding Requirements

The Act provides that the Minister of National Revenue may relieve an employer of its obligation to withhold and remit tax on an employee benefit where doing so would cause undue hardship. The amendments clarify that the Minister is prohibited to take into account the fact that the benefit is non-cash (i.e., are comprised of stock) in providing such relief. As a result of this change, an employee who exercises stock options but does not have the funds to satisfy the associated tax liability is not excused from having such tax withheld and remitted by their employer. This change applies after 2010.

The amendments also explicitly impose withholding and remittance obligations on the employer for employee stock option benefits as if the employer had paid a bonus to the employee. If the 50% deduction is available to the employee in respect of the benefit, this can be taken into account in determining the amount of the hypothetical bonus which is subject to withholding. Detailed rules applicable to bonuses are contained in the regulations to the Act. This change generally takes effect after 2010, but will not apply to CCPC stock options and will not apply to non-CCPC stock options granted before 2011 pursuant to a written agreement entered into before 4 p.m. (EST) March 4, 2010 and containing written restrictions against disposing of the optioned share for a period of time after exercise.

Thorsteinssons LLP practices in all areas of taxation law; income taxation, commodity tax, customs, and other incidental taxes, including representation in tax disputes and litigation.

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