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CRA Q&A CONCERNING EMPLOYEE STOCK OPTIONS

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Number 182

Resolutions 23 to 31 of the 2010 Federal Budget proposed changes to the rules regarding employee stock options. Legislation for these proposals has not yet been released.

Same Day Sales/Cash-outs

The March 4, 2010 Federal Budget proposed changes to the cash-out rights of employee stock options. For transactions after March 4, 2010, employees can only claim the securities option deduction if they receive cash instead of shares and the employer elects not to claim an expense for the cash-out payment. At this time, the CRA is still developing procedures concerning this election. The CRA will publish these in the near future. For now, where an employee elects to receive cash instead of shares, the employer should inform the employee in writing if they will claim the cash out as an expense. Employers must notify employees of their intention when the employee exercises the option.

Deferral of Stock Option Benefit

The March 4, 2010 Federal Budget announced changes to the rules for the treatment of employee stock option benefits. As of March 5, 2010, an employee may no longer defer the benefit.

Budget Questions and Answers: Employee Stock Options

The CRA has posted a series of questions and answers concerning the Budget proposals for employee stock options, excerpts from which are reproduced below.

1. What are the current rules in respect of cash-out rights?

Currently, when an employee acquires securities (referred to as "shares" for purposes of the Q&As) under a stock option agreement and

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certain conditions are met, the employee may be entitled to deduction equal to one-half of the stock option benefit (stock option deduction). In this case, the employer cannot claim a deduction for the issuance of a security.

Employee stock option agreements can be structured in such a manner that, if employees dispose of their stock option rights to the employer for a cash payment or other in-kind benefit (cash-out payment), the employer can deduct the cash-out payment, while the employee is still eligible for the stock option deduction.

2. What are the Budget proposals in respect of cash-out rights?

For transactions occurring after 4:00 p.m. Eastern Standard Time on March 4, 2010, the Budget proposes that the stock option deduction will only be available in situations where either:

- the employee exercises his or her options by acquiring shares of their employer; or

- the employer elects in prescribed form in respect of all stock options issued or to be issued after 4:00 p.m. Eastern Standard Time on March 4, 2010, under the agreement, that neither the employer nor any person not dealing at arm's length with the employer will claim a deduction for the cash-out payment in respect of the employee's disposition of rights under the agreement; and

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- the employer files such an election with the Minister of National Revenue;

- the employer provides the employee with evidence in writing of such an election; and

- the employee files such evidence with the Minister of National Revenue with his or her Individual Income Tax and Benefit Return for the year in which the stock option deduction is claimed.

In addition, for dispositions of rights occurring after 4:00 p.m. Eastern Standard Time on March 4, 2010, the Budget proposes to clarify that the stock option rules apply to an employee (or a person who does not deal at arm's length with the employee) who disposes of rights under an agreement to sell or issue shares to a person with whom the employee does not deal at arm's length.

Tax Deferral Election

3. What is the effect of the tax deferral election under the current rules?

Currently, where certain conditions are satisfied, employees of publicly-traded corporations who acquire securities pursuant to a stock option agreement may elect to defer the recognition of the stock option benefit until the year in which they dispose of the shares.

4. How does the Budget proposal affect the tax deferral election?

In respect of rights under an agreement to sell or issue shares exercised after 4:00 p.m. Eastern Standard Time on March 4, 2010, the Budget proposes to repeal the deferral provision.

Remittance Requirement

5. Is withholding required when employees exercise their stock options?

Yes, for employees that exercise their stock options after 2010, the Budget proposes to clarify that the employer will be required to withhold and remit an amount in respect of the taxable stock option benefit (net of any stock option deduction) to the same extent as if the amount of the benefit had been paid as an employee bonus.

In addition, for employee stock option benefits arising on the acquisition of shares after 2010, the Budget proposes that the fact that the benefit arose from these acquisitions not be considered a basis on which the Minister of National Revenue may reduce withholding requirements.

6. Will these proposals apply if there are restrictions on the disposition of the shares acquired under the stock option agreement?

The above proposals will not apply in respect of options granted before 2011, pursuant to an agreement in writing entered into before 4:00 p.m. Eastern Standard Time on March 4, 2010, where the agreement included, at that time, a written condition that restricts the employee from disposing of the shares acquired under the agreement for a period of time after exercise.

Special Relief for Tax Deferral Elections

7. Did the Budget contain any relief for employees in situations where the value of the shares acquired by them under a stock option agreement decreased significantly between the time of exercising the stock option and the disposition of the shares?

Yes, where an employee disposes of shares before 2015, and the disposition of the shares results in a stock option benefit in respect of which an election was made to defer the income recognition, the Budget proposes to permit the employee to elect in prescribed form to cause the following tax treatment for the year in which the shares are disposed;

- that the amount of the stock option deduction be equal to the stock option benefit (thereby eliminating the stock option benefit);
- that the employee be required to include in his or her income a taxable capital gain* equal to one-half the lesser of:
  - the stock option benefit; or
  - the capital loss realized on the disposition of the optioned shares;
- that the employee be required to pay a special tax equal to the proceeds of disposition from the disposition of the optioned shares (or 2/3 of the employee's proceeds of disposition, if the employee resides in Quebec).

** The taxable capital gain will not be taken into account for purposes of the GST/HST Credit, the Canada Child Tax Benefit, the tax on Old Age Security benefits, the Refundable Medical Expense Supplement and the Working Income Tax Benefit.*

Deadlines To File the Election for Special Relief

8. What are the deadlines to file an election for special relief?

The deadlines to file the election are as follows:

- for shares disposed of by the employee before 2010*, the employee's filing due date for 2010; and
- for shares disposed of by the employee after 2009**, the employee's filing due date for the year of the disposition.

** The election will be considered an application for determination under the Fairness provisions. This will allow the Minister of National Revenue to reassess the Income Tax and Benefit Returns of eligible employees who disposed of shares acquired under a stock option agreement in 2001 and subsequent years.*

*** It is important to note that this special relief is only available if an employee disposes of the shares acquired under a stock option agreement by the end of 2014.*

9. When and how will I be able to make the election?

The Canada Revenue Agency (CRA) will be making the necessary changes to forms, processes and systems to give effect to this proposed change. Please note that the CRA cannot reassess to give effect to this election until the necessary legislative amendments have received Royal Assent.

Example

10. Example

As a result of rights provided under an employee stock option agreement, John acquired 1,000 shares of his employer, XYZ Public Co., in 2005, for $1 each at a time when the shares were trading for $15 each. John elected to defer the recognition of his $14,000 ($15,000 - $1,000) stock option benefit until he disposes of the shares. When John decided to sell his shares in 2008, the shares were trading for $0.75. In 2008, John's marginal tax rate is 40% and has no taxable capital gains that would enable him to benefit from any allowable capital losses.

2008 Tax Implications under the Current Rules:

- Deferred stock option benefit brought into income $14,000
- Less: Stock option deduction $7,000
- Taxable portion of stock option benefit (employment income) $7,000
- Taxes on employment income $2,800
- Allowable Capital Loss
  - Proceeds $750
  - Adjusted cost base ($14,000 + $1,000) – ($15,000)
  - Capital loss ($14,250)
  - Allowable capital loss ($7,125)

2008 Tax Implications under the Proposed Rules:

- Deferred stock option benefit $14,000
- Offsetting deduction ($14,000)
- Taxes on employment income 0
- New taxable capital gain $7,000
- 50% of lesser of
  - a) stock option benefit of $14,000, or
  - b) capital loss of $14,250
- Allowable Capital Loss
  - Proceeds $750
  - Adjusted cost base ($14,000 + $1,000) – ($15,000)
  - Capital loss ($14,250)
  - Allowable capital loss ($7,125) ($7,125)
  - Allowable capital loss for the year ($125)
  - Special tax equal to proceeds of disposition of optioned shares $750

* * *

Hot News Items

CRA's Five-Year Administrative Policy Regarding Form NR5

Currently, a non-resident wishing to elect under section 217 of the *Income Tax Act* to pay tax under Part I on Canadian-source pensions or certain other benefits must apply each year using form NR5, *Application by a Non-Resident of Canada for a Reduction in the Amount of Non-Resident Tax Required to be Withheld*. On July 30, 2010, the CRA announced that effective January 2011, an NR5 form that has been approved will only have to be filed every five years. The notice posted on the CRA's web site that sets out this change in policy is reproduced below.

Effective January 2011, only one Form NR5, *Application by a Non-Resident of Canada for a Reduction in the Amount of Non-Resident Tax Required to be Withheld*, will have to be filed for every five tax years, if approved.

When an NR5 application is approved:

- It will always cover a period of five tax years.
- We will advise each relevant Canadian payer of the reduced rate of non-resident tax to deduct from the qualifying Canadian income for the entire approval period.
- The reduced rate of tax withholding will be maintained throughout the entire approval period, unless we have been informed of changes to the information provided on your most recently approved NR5 application (for more information, see How to amend your NR5 application [below])
- You are not required to file an amended Form NR5 to inform us of yearly increases to your pension payments due to a cost of living increase (indexing), because these changes are taken into account during the initial processing of your application.
- You will **have** to file an income tax return under section 217 of the Income Tax Act (the Act) within six months from the end of each tax year covered by the approval period.

Example

Tracy files her Form NR5 in October 2010.

If approved, it will be valid for the 2011, 2012, 2013, 2014, and 2015 tax years. Tracy will also not have to file another NR5 until October 2015, which, if approved, will cover the 2016 to 2020 tax years. Additionally, she will have

to file an income tax return under section 217 of the Act within six months from the end of each tax year covered by the five-year approval period.

How to amend your NR5 application

If, during the five-year approval period, there is a change in the amount of income you receive, you can send us an amended NR5 application. A new withholding rate may be determined based on the information provided on any amended NR5 application received. We will inform you and each relevant Canadian payer of any revisions to the withholding rate.

Note

You are not required to file an amended Form NR5 to inform us of yearly increases to your pension payments due to a cost of living increase (indexing), because these changes are taken into account during the initial processing of your application.

If you send an amended NR5 application in the first year of the five-year approval period and it's approved, there will be **no** change to the five-year approval period. If, however, you send an amended NR5 application in any other year covered by the five-year approval period and it is approved, this will be considered a new application. A new five-year approval period will begin.

How to cancel your NR5 application

You may contact us at any time to request that your NR5 application be cancelled. However, you will still be required to file your section 217 income tax return for the approved period covered before the cancellation.

Where to send requests

Requests to amend and cancel NR5 applications should be sent to the following address:

Form NR5 Processing
International Tax Services Office
Post Office Box 9769, Station T
Ottawa ON K1G 3Y4
Canada

CRA: New Tool for Gifts and Awards

The CRA has recently created a new tool to assist in determining if a gift, award or long-service award is a taxable benefit to the employee. Employers are advised to visit the CRA Web site. Click on Business, then Payroll and then Benefits and Allowances under topics for Payroll. Once there, click on Gifts, awards and social events and then on Rules for Gifts and Awards. Once there, select the "Q&A" icon where employers can answer a series of questions to help them determine if there is a taxable benefit.

CRA: Pensionability of Wage Loss Replacement Plan Payments

The CRA recently changed its policy regarding benefits paid to an employee from a wage loss replacement plan. Payments from such a plan are not considered remuneration for pensionable employment under the Canada Pension Plan. CPP contributions are not required for any benefit payments made from wage loss replacement plans.

Further details as to the extent of the change and the effective date of the change will be provided once the CRA releases such details.

MRQ Introduces Legislation To Become Agency Effective April 1, 2011

The Quebec government recently introduced Bill 107, *An Act respecting the Agence du revenue du Québec*.

This Bill establishes the Agence du revenu du Québec (Revenue Quebec Agency), which replaces the Ministère du Revenu effective April 1, 2011.

The mission of the Agency is to support the Minister of Revenue in administering and enforcing any Act under the Minister's administration and in fulfilling the Minister's other responsibilities. The Agency collects sums to be allocated to fund public services of the State and participates in the Government's economic and social missions, particularly by administering funds collection and redistribution programs.

The Agency is under the Minister's responsibility and its board of directors supervises its administration. In carrying out its mission, the Agency exercises the functions and powers of the Minister. However, the Minister may issue directives to the board of directors on matters which relate to public interest issues or the Agency's policy of collaboration with central public bodies offering certain government services such as information-based services, or which could affect public finances.

The president and chief executive officer is responsible for the management and administration of the Agency. The president and chief executive officer exercises, to the exclusion of the board of directors, the functions and

powers of the Minister with regard to any person or entity and those relating to the collection, use and communication of information concerning any person or entity.

The Agency is an independent entity, accountable to the government. It is given a governance framework and all the powers required to fulfill its mission. Employees are appointed by the Agency in accordance with the staffing plan it establishes. The Agency determines the standards and scales of remuneration, the employee benefits and the other conditions of employment of its employees, in compliance with the rules defined by the government or, as the case may be, in compliance with the applicable rules.

The Bill provides a financial framework for the Agency's activities. It establishes the Tax Administration Fund in order to pay for the services that are rendered to the Minister by the Agency. In addition to amending and miscellaneous provisions, the Bill contains the transitional measures necessary for the creation of the Agency, including provisions concerning the transfer of MRQ employees to the Agency. Lastly, it grants any employee who was a public servant with permanent tenure on being transferred to the Agency on March 31, 2011 the right to return to the public service.

Bill 107 received first reading June 8, 2010 and subscribers will be notified of its progress.

New Brunswick

Effective September 1, 2010 the minimum wage will increase to $9.00 per hour, up from the current minimum wage of $8.50.

Manitoba

Effective October 1, 2010, the general minimum wage will increase by 50 cents to $9.50, up from the current rate of $9.00.

Nova Scotia

Effective October 1, 2010, the general minimum wage will increase by 45 cents to $9.65, up from the current rate of $9.20.

Saskatchewan Holds Minimum Wage Rate Steady

The Government of Saskatchewan has announced that it is holding the minimum wage steady at $9.25 until the Minimum Wage Board completes its next minimum wage review December 31, 2011.

Need To Know

Clarification Re Simplified Logbook for Motor Vehicle Expenses

The simplified logbook initiative that was announced by the CRA on June 28, 2010 and set out in PAYSOURCE No. 181 is intended to be used for motor vehicle expense provisions. While the 2008 Federal Budget proposed to allow taxpayers to maintain a logbook for a representative sample period of time to record the usage of the motor vehicle in order to support motor vehicle expense claims and taxable benefit calculations, the logbook that was announced on June 28, 2010 is not intended to be used for purposes of taxable benefit calculations. As such, the logbook has no effect on the calculation of taxable benefits.

Minimum Wage Reminders

The new minimum wage rates are located in the "Employment Standards" section of PAYSOURCE at ¶5710, ¶5751, ¶5761, and ¶5781.

Recent Cases and Rulings

Employee Expressly Dismissed After Conversation With Employer

• • • **British Columbia** • • • Chapple worked as a restaurant manager at Il Caminetto. On January 20, 2007, an incident occurred at the restaurant. A neighbour of Chapple had made a reservation for that evening, although Chapple had not taken the reservation, and was unaware that her neighbour was coming. The neighbour became upset when she believed her table had been given away to Chapple's boss, and confronted the boss about the situation. This conversation occurred after Chapple had left the restaurant for the evening, and she did not learn about the altercation until the next day. Chapple was asked by her employer to ask her neighbour to submit a letter of apology for the incident. At the end of the discussion with her employer, Chapple believed that she had been fired. Soon after, the neighbour submitted her apology letter. A few days later, the employer determined that Chapple had been suspended, not terminated, but neglected to tell Chapple. Chapple brought a wrongful dismissal action.

The action was allowed. Chapple was expressly dismissed by the employer. The intentions of the employer were made clear in a conversation Chapple's boss had with a co-worker in the restaurant on the night of January 20, 2007, and was communicated to Chapple during the conversation with her the next day. Therefore, she was wrongfully dismissed. Chapple had worked for the employer for 13-and-a-half years, and was 38 years old. She was entitled to 15 months' reasonable notice. A substantial portion of her income was from gratuities, and therefore she was also awarded $200 a night for gratuities for the reasonable notice period. Chapple's failure to return to the restaurant to work was not a failure to mitigate her damages, given the situation. Therefore, only the salary in her new position should be considered when determining mitigation.

Chapple v. Umberto Management Ltd., (B.C.S.C.), 2010 CLLC ¶210-031.

Unreasonable for Terminated Employee To Refuse Offer from Former Employer's Customer

• • • **British Columbia** • • • Whiting worked for First Data as a senior salesperson. First Data had a contract with TD Bank, and when this contract was not renewed, Whiting lost the ability to earn sales commissions and bonuses from his corporate clients. He was offered another position in the company as director of corporate and mid-market sales, which he refused. Whiting brought a wrongful dismissal claim, alleging that he had been constructively dismissed.

The action was allowed, in part. Given the changes brought by the end of the contract with TD Bank, Whiting's job no longer existed. The product Whiting had been hired to sell was no longer available. Whiting was terminated without notice and, therefore, he was entitled to eight months' reasonable notice. However, Whiting failed to mitigate his damages. He was offered alternate employment, by First Data but it arbitrarily denied paying him a bonus and, therefore, it was understandable why he refused further employment with First Data. Whiting was also offered a position at TD Bank at the same base salary; it was unreasonable for him not to accept this particular offer. The offer was sufficient to provide Whiting with the opportunity to earn similar compensation to what he had been earning with First Data and the type of work would have been substantially the same. Therefore, Whiting was not entitled to any general damages for his wrongful termination.

Whiting v. First Data Canada Merchant Solutions ULC, (B.C.S.C.), 2010 CLLC ¶210-033.

Employee Could Have Continued in Position After Sale of Business

• • • **British Columbia** • • • The Leippis owned Brentwood Powertrain, a vehicle repair shop, and Brentwood Salvage, which purchased old vehicles to sell the parts. Silva worked for Salvage in a managerial capacity. Silva, with the knowledge and acquiescence of the Leippis, operated his own business in competition with Brentwood Salvage. Silva used his employer's computer to bid at online auctions, his employer's yard for storing vehicles and likely his employer's contacts. The Leippis decided to sell Brentwood Salvage. The new owners wanted to keep Silva as an employee. After receiving a letter from Silva asking for a 33 per cent wage increase, the buyers decided to buy the business and convert it to a metal recycling operation. Silva was told he was being terminated, and was given his wages owed, as well as holiday pay. Prior to the purchase of the business, Silva had purchased a loader from Leippi for $3,000 and resold it for $8,000 to Steel Pacific. Silva knew that Steel Pacific was interested in the loader but did not inform Leippi of this because he wanted to make a profit for himself. According to the new employer, this constituted cause for termination. However, the new employer was not aware of these facts until after Silva was terminated. Silva brought a wrongful dismissal action.

The action was allowed. However, no damages were awarded. With respect to the resale of the loader, in any other employment situation the transaction would have been a breach of an employee's duty of honesty and fidelity. This employment relationship was unusual; however, since the employer had allowed Silva for several years to engage in the operation of a competing business, using the employer's facilities, with no complaint from the employer, and with little or no supervision or accountability. Therefore, the loader transaction, which would otherwise have resulted in dismissal, did not support more than discipline short of dismissal. In addressing the issue of mitigation, the Court noted that Silva had the same job available to him after the sale, with the same or similar working conditions, and at the same salary. The only significant difference would have likely been the loss of his ability to carry on the side business. Despite the fact that his employer condoned Silva's side business, this did not make it an implied term of his employment contract. His employer could have ended the side business without breaching the terms of the contract. As a result, Silva was wrongfully dismissed, but suffered no damage that could not have been avoided by his continuing to work for the new owners, without operating his side business.

Silva v. Leippi, Leippi, Brentwood Salvage dba Brentwood Salvage and Powertrain, (B.C.S.C.), 2010 CLLC ¶210-034.

Reimbursement for Cost of Household Items on Employee Relocation Was Taxable Benefit

The taxpayer's employer in Australia was taken over by Placer Dome, and the taxpayer moved from Australia to Vancouver, B.C. in April 2003 to accept employment at Placer Dome's head office. In 2006, Placer Dome itself was taken over by Barrick Gold Corporation ("Barrick"), and the taxpayer chose not to stay with Barrick. In a reassessment dated April 27, 2007, the Minister included in the taxpayer's income for 2003 $6,415 paid to her by Placer Dome to reimburse her for household items she purchased upon her move from Australia to Vancouver. The taxpayer appealed to the Tax Court of Canada. Because the notice of reassessment referred to an amount in an amended T4 slip prepared by Barrick that the taxpayer said she had not received, she argued that the notice of reassessment itself was confusing, misleading, difficult to understand, and therefore defective and void.

The taxpayer's appeal was dismissed. There is no prescribed form for an assessment to be valid. In this case, the notice of reassessment was valid, since it set out the increase in the taxpayer's income and tax payable, and referred to the amended T4, which she understood to relate to income from employment. The $6,415 also constituted a net economic benefit for the taxpayer, and was therefore properly included in her income under s. 6(1)(*a*) of the *Income Tax Act*. The Minister's reassessment was affirmed accordingly.

Suffolk, (Tax Court of Canada), 2010 DTC 1201.

Director Did Not Act With Due Diligence – Liable for Company's Unremitted Source Deductions

The taxpayer was the sole director and shareholder of a company that failed to remit net GST and federal tax source deductions. As the Minister was not able to recover these taxes from the company, the taxpayer was held jointly and severally liable with the company and assessed personally for the unremitted deductions. He was aware of the failure, but chose to continue operating the business in the hopes that things would improve. Key creditors of the company whose services were needed to continue operating the business were paid. The taxpayer appealed the assessments to the Tax Court of Canada on the basis that he acted with due diligence.

The taxpayer's appeal was dismissed. He was personally liable for the company's failure to make GST and federal tax source deductions. He was aware of the financial difficulties the company was facing, and it was up to him to ensure that the GST was collected and the source deductions remitted. While it may be reasonable from a business point of view to continue operating a business, the failure to make remittances to the government was not due diligence on the part of the taxpayer.

Winther, (Tax Court of Canada), 2010 DTC 1226.

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