



Executive Compensation

By Ken Hugessen

We Still Have Options

The double-deductibility of stock appreciation rights is history. Employers shouldn't lose too much sleep

The recent federal budget included a number of proposed changes to the tax code with the objective of “closing unfair tax loopholes.” A number of these changes will impact most, if not all, of the companies and their employees that use employee stock options—still the most prevalent form of long-term incentive compensation in Canada.

Gone, from the employee's perspective, is the right when exercising their options to defer taxation on up to \$100,000 worth of gains realized until those securities are sold. On the plus side, option holders who have deferred taxation on their gains, only to have seen the value of those shares fall, no longer face a tax liability that's greater than the shares' current value.

From the company's perspective, only one new change is really significant—and it relates exclusively to companies that issue Stock Appreciation Rights (SARs) in tandem with stock option grants.

Specifically, the government has done away with the opportunity previously provided by the tax rules that enabled both employees and employers to receive a tax deduction when an employee exercised SARs instead of options. Under the new rules, gains realized by an employee will continue to be eligible for preferential tax treatment only where the employer elects to forego its tax deduction. While that might sound like companies are in a preferred position, the reality of the implementation favours the employee.

Prior to the March budget, when a stock option was granted to an employee in tandem with stock appreciation rights, he or she could elect, after vesting conditions were satisfied, to take the gains accrued under the options/SARs

in the form of cash, rather than paying the exercise price and acquiring the shares. As long as the choice was that of the employee, the employee would enjoy the preferential tax treatment currently afforded to stock options—i.e., only 50% of the gain is included in income for tax purposes. At the same time, the employer could claim a deduction for the gross benefit delivered to the employee.

The appeal was obvious. Being able to use the tandem SAR feature alongside stock option

the deduction if an employee chooses the cash-out alternative (i.e., the SAR). That employee then has two alternatives:

- (i) Exercise the option and pay tax on the gains at 50% of his or her marginal tax rate (employer gets no deduction);
- (ii) Exercise the SAR and pay tax on gains at 100% of his or her marginal tax rate (employer gets a full deduction),

An informed and rational employee option/SAR holder—in the face of an employer unwilling to part with the deduction voluntarily—will choose to exercise the option rather than the SAR as it cuts his or her tax bill in half, denying the employer the opportunity to take the deduction they sought.

In short, the employer's choices are to magnanimously give up the deduction, or lose it unwillingly.

To prepare for this reality, employers should take the following three steps:

- (i) Assess the impacts of deciding to forego or not forego the tax deduction on existing option/SARs;
- (ii) Review the ongoing appropriateness of an option/SAR plan;
- (iii) Communicate to employees the company's intentions going forward. Where a tax benefit for the participants is to be maintained, be sure they understand this comes at a cost to the company.

Firms should also bear in mind that the preferential tax treatment on options in Canada is still among the best in the world, and a substantial benefit to employees and employers.

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Employers can give up the deduction or lose it unwillingly

grants put a company in line to qualify for the tax deduction on the value it delivered to option holders who cashed out. Public documents suggest that a number of high-profile firms have such awards outstanding including Agrium, EnCana and Bank of Nova Scotia.

As noted, under the new rules, the choice of taking the deduction appears to be in the hands of the employer; however, it is actually the employee who “holds all the cards.” Imagine a scenario in which the employer indicates to option/SAR holders that the company will take