

**Stock Option Plans and Other
Equity-Based Incentives**

**Julie Y. Lee
Osler, Hoskin & Harcourt LLP**

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STOCK OPTION PLANS AND OTHER EQUITY-BASED INCENTIVES

by
Julie Y. Lee

I. INTRODUCTION

In one form or another, most publicly-traded corporations as well as many private corporations offer equity-based incentive plans to their employees. Corporations are motivated to provide equity-based incentives by a variety of factors, including competitive pressures, economic constraints, shareholder expectations and employee demands. As a result, such incentive plans are very common.

Equity-based incentives come in a variety of forms. This paper will focus on the more common equity-based incentive plans for which tax advice is regularly sought, namely:

1. stock option plans,
2. stock bonus plans,
3. stock purchase plans, and
4. phantom stock plans.

This paper provides an overview of the principal income tax issues relating to these common stock incentives. In addition, given the large number of income trusts still extant, a separate section considers the equity incentives available to employees of income trusts. This paper is not intended to be an exhaustive review of all relevant tax considerations affecting the particular plans. Moreover, depending on the circumstances, considerations under corporate or securities law or accounting standards may take precedence over tax issues.

The following discussion is based upon the current provisions of the *Income Tax Act* (Canada)¹ (the “ITA”) and the regulations issued thereunder (the “Regulations”), all proposals to amend the ITA announced prior to March 31, 2010 by or on behalf of the Minister of Finance and the

author's understanding of the published administrative and assessing policies and practices of the Canada Revenue Agency (the "CRA").

II. TAX FRAMEWORK FOR EMPLOYMENT INCOME

A. Income Taxed When Received

The benefit realized by an employee from a stock incentive plan constitutes income from employment for purposes of the ITA. It is, therefore, important to have a basic understanding of the general tax framework for the taxation of employment income and where stock incentives fit within that framework. The general rule is that employees are cash-basis taxpayers; that is to say, employment income is taxed when it is received by the taxpayer. In this regard:

- Subsection 5(1) provides that "a taxpayer's income for a taxation year from an office or employment is the salary, wages and other remuneration, including gratuities, *received* by the taxpayer in the year" (emphasis added).
- Paragraph 6(1)(a) requires the taxpayer to include in computing his or her income for a taxation year as income from an office or employment "the value of board, lodging and other benefits of any kind whatever *received or enjoyed* by the taxpayer in the year in respect of, in the course of, or by virtue of an office or employment" (emphasis added), subject to a limited number of exceptions.

B. Exception for Deferred Amount under an SDA

While the general rule is that employees are taxed on their employment income on a received basis, a significant exception is made for "deferred amounts" under a "salary deferral arrangement" ("SDA").²

The SDA rules have been part of the Canadian tax landscape for over 20 years. These rules were introduced in 1986 as a response to the wide-spread use of deferred compensation plans, many of which were structured to permit the employer an immediate deduction while deferring tax liability to the employee until the employee received payments under the plan. The SDA rules

have effectively precluded the use of standard deferred compensation programs whereby employees could choose to defer a percentage of the salary and/or bonuses for a period of time. This type of deferred compensation arrangement is now generally available only for taxpayers who are professional athletes on league teams.³ For all other taxpayers, the opportunities for deferral are much more limited. Nonetheless, certain types of incentive arrangements which involve a future payout are still viable, provided that they are designed to avoid SDA characterization.

The definition of an SDA is quite broad and applies both to funded and unfunded plans and arrangements. In general terms, an SDA is any arrangement under which any person has the right in a taxation year to receive an amount after the year where it is reasonable to consider that *one of the main purposes* for the creation or existence of the right is to postpone tax payable under the ITA by the taxpayer in respect of *salary or wages for services rendered* by the taxpayer in the year or a preceding year.

It should be noted that the SDA definition covers not only absolute rights but also conditional rights. In the case of a conditional right to the deferred amount, the only exception is for a condition where there is a substantial risk that the condition would not be satisfied (i.e., if there is a substantial risk of forfeiture).

If an arrangement constitutes an SDA, the following consequences result:

- Subsection 6(11) deems an amount equal to the deferred amount, for the purposes of paragraph 6(1)(a), to have been received by the taxpayer as a benefit in the year. Thus, the deferred amount is required to be taxed *immediately* rather than upon actual receipt in the subsequent year.
- Subsection 6(12) applies to the interest element accruing on a deferred amount by deeming “any interest or other additional amount that accrued . . . to the end of the year” to be a deferred amount for purposes of subsection 6(11).
- Paragraph 8(1)(o) provides the taxpayer with a deduction in respect of a deferred amount previously included in the taxpayer’s income that is forfeited in the year.

- Paragraph 20(1)(oo) permits the employer a deduction for deferred amounts included in the taxpayer's income under paragraph 6(1)(a); in other words, the employer deduction is timed to the employee's taxation.

The impact of the SDA rules are of particular significance in the context of phantom stock plans, which will be discussed later herein.

C. Exception for Agreements to Sell or Issue Shares

A major exception to both the "taxed on receipt" and the SDA rules is to be found in section 7 which governs, among other things, agreements by corporations to sell or issue shares to employees. The types of plans that commonly fall within section 7 are stock options plans and stock bonus plans. While section 7 and related rules will be examined in detail in part III below, the following general comments about the application of the rules can be made:

- Section 7 sets out a specific tax regime for certain stock incentives granted to employees. In general terms, section 7 overrides both paragraph 6(1)(a), which taxes the value of benefits received or enjoyed in the year, and subsection 6(11), which deems a deferred amount under an SDA to have been received as a benefit in the year.
- Paragraphs 7(1)(a) to (e) provide the general rules for the timing of taxation of the benefit realized under a stock incentive that falls within section 7.

Against the backdrop of these basic rules governing employment income taxation, we can now turn to the tax treatment of the specific types of stock incentive plans.

III. TAXATION OF EMPLOYEE STOCK OPTIONS

The employee stock option plan is the most popular stock incentive arrangement. In recent years, the downturn in the global markets and numerous accounting scandals that have laid low former corporate giants, such as Enron, WorldCom and Nortel, have tarnished employee stock options as a compensation tool and have caused many corporations to explore alternative long-term incentives, a number of which are covered in this paper (see Appendix C for a summary of

the differing tax considerations.) Nonetheless, the stock option plan continues to be the most common long-term incentive. Indeed, in recessionary times, lower stock values may spur some corporations to grant stock options more readily as the upside potential would appear to be greater. The stock option plan, however, is subject to the greatest number of tax rules, several of which have been significantly altered as a result of the 2010 federal budget tabled on March 4, 2010 (“Budget 2010”). For these reasons, the greater part of this paper will be devoted to the tax treatment of stock options.

Employee stock options have traditionally been used to achieve a variety of business objectives. Among other things, they act as:

- a recruitment tool in a competitive market;
- a motivator to employee performance;
- a means of retaining mobile talent; and
- a cost-effective compensation strategy for businesses with a need or desire to conserve cash.

Favourable income tax treatment is the key to the attractiveness of employee stock options. The federal tax rules provide tax-favoured treatment (less so following Budget 2010) for certain stock options and are generally mirrored in provincial tax legislation. The following discussion will first cover the ITA tax rules of general application as well as the special rules for options granted by Canadian-controlled private corporations⁴ (“CCPCs”). The impact of Budget 2010 on public corporation stock options will then be summarized.

A. ITA Taxation of Stock Options – General Rules

1. Application of Section 7 of the ITA

The basic tax rules governing employee stock options in the ITA are found primarily in section 7. Section 7 applies when a corporation agrees to sell or issue shares of its capital stock or the

capital stock of a related corporation to its employees or the employees of a related corporation. A stock option is an agreement to sell or issue shares.⁵

Stock options that do not qualify for special treatment as CCPC options or public corporation options will be treated as follows:

- The grant of a stock option is not a taxable event to the employee.⁶
- Tax consequences for the employee arise in the circumstances outlined in subsection 7(1):
 - (i) Pursuant to paragraph 7(1)(a), where the employee has acquired shares under the agreement (i.e., upon exercise of the option), a benefit equal to the excess of the value of the shares at the time of acquisition over the amount paid or to be paid by the employee for the shares (and any amount paid by the employee to acquire the right to acquire the shares) shall be deemed to have been received by the employee because of the employee's employment in the taxation year of acquisition.
 - (ii) Under paragraph 7(1)(b), where the employee has transferred or otherwise disposed of rights under the agreement in respect of some or all of the shares to an arm's length person (including the corporation that granted the option), a benefit equal to the value of the consideration for the disposition less any amount paid by the employee to acquire the rights is deemed to have been received because of employment in the year of the disposition.
 - (iii) Paragraphs 7(1)(c) and (d) contemplate the situation where shares are acquired, or rights under the agreement have been disposed of, by a person with whom the employee is not dealing at arm's length. The employee is deemed to have received an employment benefit at the time the non-arm's length person either acquires the shares or receives consideration for the disposition of rights under the agreement to an arm's length person. The calculation of the benefit is the same as in paragraphs 7(1)(a) and (b), as applicable. However, if the employee is deceased at the time the non-arm's length person acquires the shares or disposes

of rights, it is the non-arm's length person who is deemed to have received the benefit as income from the duties of an employment performed by the person in that year in the country in which the employee primarily performed the duties of the employee's employment.

- (iv) Paragraph 7(1)(e) applies if the employee has died owning a right to acquire shares under the agreement. In that event, a benefit equal to the value of the right immediately after the death less any amount paid for the right shall be deemed to have been received in the taxation year of death by the employee because of the employee's employment. (The benefit deemed to be received under any of the provisions of subsection 7(1) will be referred to herein as the "Section 7 Benefit".)

Once the applicable provision in subsection 7(1) deems the employee to have received an employment benefit, the employee is required to include such benefit in computing income for the year as income from an office or employment pursuant to paragraph 6(1)(a). The most common event is the exercise of the option by the employee, resulting in a paragraph 7(1)(a) income inclusion.

- The full amount of the Section 7 Benefit is added to the employee's cost of the shares in computing the employee's adjusted cost base⁷ for purposes of calculating gain or loss on a subsequent disposition of the shares.
- Shares acquired by an employee are generally capital property for purposes of the ITA.⁸ The employee's adjusted cost base of each share at any time is generally determined by reference to the average cost of all shares of the same class held by the employee at that time, whether acquired through stock options or otherwise.⁹ On a disposition of shares, the employee will realize a capital gain (or loss) equal to the amount by which the net proceeds of disposition exceed (or, are exceeded by) the employee's adjusted cost base of such shares.¹⁰ One half of capital gains ("taxable capital gain") net of one half of capital losses ("allowable capital loss") realized in the year is included in the employee's income for the year and taxed at ordinary rates.¹¹ If allowable capital losses exceed taxable capital gains realized in the year,

the net capital loss may generally be carried back three taxation years and forward to future years to offset taxable capital gains realized in those years.¹²

- No deduction is available to the corporation (or any person) in respect of the Section 7 Benefit received by the employee.¹³
- The above rules apply equally to options granted by mutual fund trusts to their employees to acquire trust units, as described further below.¹⁴

2. The Paragraph 110(1)(d) Deduction

The ITA provides an incentive for fair market value (“FMV”) stock options. When the exercise price is fixed at an amount not less than the FMV of the share at the date the option is granted, and provided certain other conditions are met, the employee may claim a deduction under paragraph 110(1)(d) in computing taxable income for the year equal to one half of the Section 7 Benefit. If the deduction is available, the employee will be taxed only on one half of the Section 7 Benefit for the year in which the option is exercised. In effect, an FMV stock option that meets the other pre-conditions is taxed at capital gains rates on exercise. The other pre-conditions to the deduction are as follows:

- The employee must be dealing at arm’s length with the corporation granting the option (and the employer, if different from the issuing corporation) immediately after the option is granted. Employees are generally regarded as dealing at arm’s length with their employer.
- The share must be a “prescribed share” when it is sold or issued to the employee.¹⁵ An ordinary common share of a corporation would normally qualify as a prescribed share, but a careful review of the requirements for prescribed share status at the time of sale or issue of the share is essential to confirm the availability of the deduction.

If the employee is entitled to the paragraph 110(1)(d) deduction, the shares are listed on a prescribed stock exchange and the employee makes a gift of the shares within 30 days of their acquisition to a qualified donee (e.g., any registered charity), paragraph 110(1)(d.01) provides an additional deduction equal to one half of the Section 7 Benefit. This rule is intended to parallel

paragraph 38(a.1), which reduces the capital gains inclusion rate to zero when a taxpayer donates publicly-listed securities to a registered charity.¹⁶ If instead of donating the shares, the employee directs a broker to immediately dispose of the shares and pay some or all of the proceeds to a qualified donee, subsection 110(2.1) deems the employee, for purposes of paragraph 110(1)(d.01), to have made a gift of the shares to the qualified donee.

B. CCPC Stock Options

The foregoing general rules are modified in certain key respects in the case of CCPC stock options.

Agreements by a CCPC to sell or issue shares to arm's length employees have historically been treated more favourably than stock options issued by other corporations. Although the Section 7 Benefit is still measured at the time the employee acquires shares under a CCPC stock option, the Section 7 Benefit is not subject to tax until the year of disposition of the shares.¹⁷ This deferral of taxation, which occurs automatically, is in recognition of the illiquidity of private company shares. Further, even if the exercise price is less than the FMV of the share at the date of grant of the stock option, provided that the employee has not disposed of the share (other than as a consequence of death) within two years of its acquisition, the amount of the Section 7 Benefit may be reduced by one half.¹⁸ Of course, if it is a FMV option, the one-half deduction under 110(1)(d) would be available, regardless of the holding period.

A further point of interest is that the deferral of taxation to the year of disposition of the shares remains available even though the corporation is no longer a CCPC at the date the stock option is exercised.¹⁹ Thus, for example, stock options granted by a CCPC prior to the time it becomes a public corporation would retain the tax benefits accorded to CCPC options. The use of stock options in such circumstances would provide a valuable incentive to key employees whom the corporation wishes to reward and retain in advance of making an initial public offering.

C. Budget 2010 and Stock Options on Publicly-Listed Shares

1. Repeal of Deferral Election

Under rules introduced in the 2000 federal budget (subsections 7(8) to (16) of the ITA), employees of corporations whose shares are listed on a prescribed stock exchange were also allowed to defer tax on their stock options.²⁰ Employees of public corporations could, in certain circumstances, elect to defer the income inclusion of the Section 7 Benefit until the year the shares are disposed of (or the year of death or cessation of Canadian residence, if earlier).²¹ Budget 2010 tabled on March 4th proposes to repeal the deferral election for all option exercises occurring after 4:00 p.m. EST on March 4, 2010. In effect, for non-CCPC stock options, the pre-2000 federal budget tax treatment has basically been restored, subject to certain modifications.

The rationale given for the repeal is that it will prevent situations in which an employee is unable to meet his or her tax obligations as a result of the decrease in the value of shares following the election to defer recognition of the employment benefit.

2. Special Relief for Taxes Deferred Prior to March 4th, 2010

Indeed, since the introduction of the deferral in 2000, there have been recessionary periods (most recently, late 2008 through mid-2009) when many employees of public corporations who took advantage of the tax deferral election have seen the value of their optioned shares plummet after acquisition. In many cases, the shares are (or were) worth less than the taxes deferred at the time of option exercise.

Special relief is provided in Budget 2010 for these individuals, provided that they dispose of their optioned shares before 2015.²² Employees will be permitted to elect to limit their tax liability to the proceeds from the disposition of their shares. Specifically, an individual who makes the election will pay a special tax equal to the proceeds from the disposition of the shares (or two-thirds of the proceeds in the case of Quebec residents) and may claim a paragraph 110(1)(d) deduction equal to the full amount of the Section 7 Benefit in computing taxable income.

Furthermore, an amount equal to one half of the lesser of the Section 7 Benefit and the capital loss realized on the disposition of the shares will be included in the individual's income as a taxable capital gain. That gain may be offset by the allowable capital loss on the optioned shares. In effect, an employee electing to pay a reduced amount of taxes will not also be able to benefit from the full amount of capital loss arising from the disposition.

Only stock option benefits for which an election to defer taxation has been made will qualify for this special elective tax treatment.²³ To benefit from this special treatment, employees must elect on or before their tax return filing deadline for the year in which they dispose of their shares, with 2014 being the final year in which disposition must occur for purposes of this special election. The election is also available retroactively for individuals who disposed of their securities before 2010 and elect on or before their tax return filing deadline for 2010 (generally April 30, 2011).

The supplementary information accompanying Budget 2010 notes that this special tax treatment will provide relief for federal income tax liabilities on qualifying deferred stock option benefits as well as provincial and territorial income tax on such benefits for residents of provinces and territories participating in a Tax Collection Agreement. Amendments are to be made to allow for the sharing of the special tax with such provinces and territories.

While the deferral election rules for public corporation stock options will be of historical interest only once the Budget 2010 measures are enacted, a summary of the existing rules is set out in Appendix A hereto for information purposes.

For an illustration of the mechanics of the special relieving rules, please see Appendix B.

D. Additional Measures in Budget 2010

Budget 2010 announced two other significant changes to the tax rules governing stock options.

1. Cash-Out of Stock Options

Under the existing rules in the ITA, an employee who has a share appreciation right (“SAR”) connected with his or her stock option and chooses to exercise the SAR for cash rather than exercising the stock option (which is surrendered concurrently with the SAR exercise) is treated in the same manner as though he or she had exercised the stock option. Thus, if the exercise of the stock option would have entitled the employee to claim the paragraph 110(1)(d) deduction, the employee may similarly claim the 50% deduction upon the receipt of a cash payment following the exercise of the SAR. In that circumstance, the employer making the cash payment would also be entitled to claim a corporate tax deduction in the amount of the cash payment. The prohibition contained in paragraph 7(3)(b) would not apply as the benefit conferred on the employee would not have arisen through the sale or issuance of the share to the employee.

Budget 2010 proposes to prevent a deduction by both the employer and the employee where option rights are disposed of to the employer for cash. In such a circumstance, the employee will be denied the paragraph 110(1)(d) deduction unless the employer files an election with the CRA to forgo the deduction for the cash payment. The employer must provide the employee with a statement that such election has been made, and the employee must file the statement with the employee’s tax return for the year in which the employee is claiming the paragraph 110(1)(d) deduction.

It appears that the employer election may be made on an award by award basis. In other words, the election does not have to be made in respect of the stock option plan as a whole, nor does it have to be made in respect of all outstanding option awards to a particular employee. However, the employer election must apply to all options granted under a particular award to the employee.

This budget measure applies for cash-out transactions occurring after 4:00 p.m. EST on March 4, 2010. (Budget 2010 also proposes to amend the ITA to “clarify” that the disposition of rights under a stock option agreement by an employee to a non-arm’s length person for cash will result in an employment benefit at the time of the disposition.)

2. *Employer Tax Withholding and Remittance Requirement*

The final significant change applicable to stock options proposed in Budget 2010 relates to the tax withholding and remittance obligations by the employer in respect of shares acquired by an employee after 2010 under an employee stock option agreement. A proposed amendment to section 153 of the ITA will require employers to remit tax in respect of the stock option benefit, net of any paragraph 110(1)(d) deduction available to the employee, at the time of the exercise of the stock option to the same extent as if the amount of the benefit had been paid as a cash bonus. Furthermore, employers will no longer be able to reduce tax withholding on the grounds of hardship for the employee.

This clarification of the employer's tax withholding and remittance obligations finally eliminates the uncertainty inherent in the CRA's long-standing administrative practice in connection with the exercise of a stock option in which the taxable benefit arises directly as a result of the issuance of shares by the employer to the employee. The issue has been how tax is to be withheld when the transaction does not involve a payment of cash from the employer to the employee.

While the CRA takes the general position that employers should withhold amounts in respect of CPP and income tax from stock option benefits, the CRA has generally not enforced the withholding obligation in situations where no other cash remuneration has been paid to an employee, the stock option benefit is large in relation to an employee's cash remuneration or withholding would cause undue hardship to an employee.²⁴ In reliance on the CRA's administrative policy, many employers have not done any tax withholding when employees exercise stock options and purchase shares.

Two points should be noted with respect to the new mandatory remittance measure. First, the measure applies in respect of shares acquired by employees **after 2010**. Therefore, for options exercised before the end of the 2010 year, it would appear that employers may rely on the CRA's current administrative practice. Secondly, the new requirement does not apply to options granted before 2011 pursuant to a written agreement entered into before 4:00 p.m. EST on March 4, 2010 where the agreement includes a written condition restricting the employee from disposing of the

optioned shares for a period of time after exercise. Again, when such options are exercised, the CRA's current administrative practice presumably should apply.

E. Other Common Tax Issues

1. Replacing Stock Options

Subsection 7(1.4) permits stock options to be replaced on a "rollover" basis, provided certain requirements are satisfied.²⁵ The rollover treatment applies where:

- (a) the taxpayer disposes of rights under an agreement to acquire shares of a particular corporation that made the agreement or of a corporation with which the particular corporation does not deal at arm's length (which rights and shares are referred to in the ITA as the "exchanged option" and the "old shares");
- (b) the taxpayer receives no consideration for the exchanged option other than rights under an agreement with the particular corporation, a corporation with which the particular corporation does not deal at arm's length, a corporation formed on the amalgamation or merger of the particular corporation and one or more other corporations, or a corporation with which such amalgamated or merged corporation does not deal at arm's length, to acquire shares (which rights and shares are referred to in the ITA as the "new option" and the "new shares"); and
- (c) the total value of the new shares immediately after the disposition less the exercise price under the new option does not exceed the total value of the old shares immediately before the disposition less the exercise price under the exchanged option.

If these requirements are satisfied, the replacement of the old option has no immediate tax consequences. Further, when the new option is exercised, the 50% deduction in paragraph 110(1)(d) would be available as long as the exercise price under the old option was not less than the FMV of the old share at the date of grant of the old option and the other conditions in paragraph 110(1)(d) are satisfied.

This rollover treatment would be useful in any takeover situation where it would be desirable for employees who hold options of the target corporation to be provided with options in the acquiror corporation (or its parent) instead. Provided that the value of the new option does not exceed the value of the old option, the employee can expect to be taxed only upon the exercise of the new option. Moreover, provided the new shares are prescribed shares at that time, the paragraph 110(1)(d) deduction which was available in respect of the original option is generally preserved.

The rollover rule also applies to the situation where the corporation itself may wish to replace an existing option with a new option. For example, in the case of a publicly-traded corporation whose shares have gone down in value since an option was granted to an employee, the “out of the money” or “underwater” option can be replaced by a new option with an exercise price equal to the current trading price of the share. The result would be an enhanced potential for the employee to realize a benefit from the option. For example, a share that may have been trading at \$20 at the date the option was granted (and the exercise price would have been set at \$20) may have dropped to \$10. The incentive value of the option has similarly plummeted. If the exercise price could be reduced to current trading value, the incentive value might be restored. The rollover mechanism in subsection 7(1.4) of the ITA would permit the replacement of the existing option with a new option at the new exercise price without adverse tax consequences to the employee.²⁶

Under pending amendments to section 110, the paragraph 110(1)(d) deduction will be preserved if, rather than an exchange of options, the existing stock option is simply amended to reduce the exercise price. In common parlance, such an amendment is referred to as “repricing”. The effect of proposed subsections 110(1.7) and (1.8) is to deem an exercise price reduction to have been effected by way of an exchange, thus ensuring that the employee remains eligible to claim the paragraph 110(1)(d) deduction.²⁷ Because of the precipitous drop in stock values over the recent period, dozens of public companies in the U.S., such as Google, Starbucks and Intel, have been repricing their stock options.²⁸ Canadian companies are likely not far behind, but repricing raises a whole host of non-tax issues, including corporate governance and shareholder relations.

2. Option Buyouts on a Takeover

In the course of a bid by one corporation (“Acquiror”) to purchase all of the shares of another corporation (“Target”), an important consideration revolves around the outstanding stock options held by employees of Target. Generally speaking, Acquiror will wish to eliminate the possibility of minority shareholders. At the same time, the employees of Target holding stock options will want to obtain the same economic benefits of the takeover as the shareholders of Target.

If the options are exercisable, the employees could exercise the options, acquire the shares and then tender their shares to the bid. In this regard, many stock option plans provide for accelerated vesting of options on the happening of certain events, including a pending change in control. As a short cut to this process, as well as to obtain certainty that all of the options will be eliminated, an arrangement can be made whereby Target will offer cash for all of the outstanding options held by its employees. The key question is whether the cash payment by Target will be deductible in the same manner as cash payments had been under an option/SAR plan, as discussed above. It should be noted that the Budget 2010 measure precluding a deduction by both the employer and the employee appears to apply in this circumstance as well. However, even if no employer election is filed to forgo a deduction, deductibility remains an issue.

The answer depends upon whether the cash payment by Target is a payment on account of capital within the meaning of paragraph 18(1)(b) of the ITA. In *The Queen v. Kaiser Petroleum Limited*,²⁹ the Federal Court of Appeal held that the cash payments by the taxpayer corporation to its employees to obtain cancellation of their stock options were on account of capital and, therefore, non-deductible. The taxpayer, formerly known as Ashland Oil Canada Ltd. (“AOCL”), was controlled by Ashland Oil Inc. (“Ashland US”), which entered into an agreement to sell its shares of AOCL to Kaiser Resources Ltd. (“Kaiser”). AOCL had at that time a stock option plan under which a number of options were outstanding, the majority of which were exercisable. The sale agreement between Ashland US and Kaiser dealt with the employees’ stock options in the following terms (at p. 6604):

Prior to the Closing Date, AOCL shall (i) make an offer to each of its employees who holds an employee’s stock option of AOCL to obtain the cancellation of such option upon the payment by AOCL to such employee of an amount per share covered by such option equal to the difference between the exercise price per share under such option and Cdn. \$33.50 per share [i.e., the bid price] and

(ii) upon the request of any such employee, to the extent such employee's option may not be exercisable by its terms, amend such terms so that the option shall become immediately exercisable.

This offer was made by AOCL and accepted by the vast majority of the optionees. The Board of Directors of AOCL then cancelled the stock option plan. In its tax return for the year, AOCL included the amount paid to the employees as a current, deductible expense. The Minister disallowed the deduction on the grounds that the amount was an outlay or a payment on account of capital within the meaning of paragraph 18 (1)(b) of the ITA.

The Federal Court of Appeal overturned the trial judge's decision and agreed with the Minister's capital characterization of the payment. The court stated (at p. 6606):

The respondent, in buying out rights under the plan, parted with an asset (the purchase price) and effected a sterilization of future issues of shares. The disbursement made was a once and for all payment which had a direct effect on the capital structure of the corporation. In fact, the stock option plan was later cancelled.

The court did not dispute the respondent's contention that the plan originated as a form of compensation and that immediate compensation of the employees was one reason for the plan's termination. However, the court found that the dominating factor was the reshaping of the capital structure of AOCL's organization.

The decision in *Kaiser* was consistent with an earlier decision of the Federal Court, Trial Division in *Canada Forgings Ltd. v. The Queen*³⁰ although the court in *Kaiser* noted two factual differences in *Canada Forgings*. In that case, the evidence showed that the Acquiror desired to obtain all of the shares in the taxpayer corporation and had made separate agreements with the particular optionees who undertook not to exercise their options and who further agreed to give the Acquiror the right to purchase the option shares should the company refuse the agreement to make the cash payment to each optionee. The court in *Canada Forgings* concluded that the contractual provisions established an intention to insure the acquisition by the Acquiror of the option shares (a capital transaction) rather than an intention to pay a bonus to employees (a normal business expense).

The CRA has commented on the decision in *Kaiser* and appears to be willing to adopt a more flexible approach. In particular, the CRA has stated that the result in *Kaiser* follows from facts

particular to that case and is not inconsistent with the CRA's position that a cash payment made to an employee pursuant to a stock option agreement would generally be deductible to the employer pursuant to section 9 of the ITA.³¹ It seems that the CRA is interpreting *Kaiser* narrowly. Therefore, if the particular facts concerning a buyout of stock options in a takeover or other major reorganization are more favourable than those in *Kaiser* (e.g., if the outstanding options have an existing cash SAR feature), it might be possible to take the position that *Kaiser* is inapplicable.

In the more recent case of *Imperial Tobacco Canada Ltd. v. The Queen*³² the Tax Court of Canada was able to distinguish *Kaiser* on the facts. In that case, the appellant, Shoppers Drug Mart Limited ("SDM" - Imperial Tobacco was successor by amalgamation to SDM) paid in excess of \$54 million to its parent Imasco Limited ("Imasco") to reimburse it for payments made by Imasco to SDM's employees on the surrender of options held by them to acquire shares of Imasco under the Imasco stock option plan. SDM was denied the deduction in computing its income for 1999 by reason of paragraph 18(1)(b) of the ITA. Although the employee stock options were cashed out in the course of the acquisition by British American Tobacco p.l.c. ("BAT") of the common shares of Imasco held by the public, the cash payments were contemplated by the terms of the Imasco plan, which had been amended prior to the BAT transaction to provide for a cash SAR feature at the discretion of the optionholder. Chief Justice Bowman distinguished *Kaiser* on the grounds that SDM, as a separate corporate entity, was not being reorganized. He stated:

Here, the rearrangement of the Imasco corporate structure did not impinge in any way on the corporate structure of SDM. Desjardins J.A. appears to have felt that the cancellation of the stock option plan of the appellant, Kaiser Petroleum Ltd., was an advantage for the lasting benefit of the appellant. I do not see how a payment by SDM to Imasco to reimburse it for payments made to employees of SDM created or achieved anything of lasting benefit to SDM. The business of SDM went on as usual . . . The fact that a subsidiary reimburses its parent for compensation paid to the subsidiary's employees does not turn the payment into a capital expenditure just because the parent company is in the midst of a corporate reorganization. (At page 2049.)

While the Imperial Tobacco case is very helpful where the cash-out payments for stock options is made by a company whose capital structure is not being reorganized, it does not purport to override the *Kaiser* rationale. Careful consideration of *Kaiser*, as well as *Imperial Tobacco*, will be required in reviewing the deductibility of stock option cash-out payments during a takeover or

other corporate reorganization. Moreover, assuming that the Budget 2010 measure preventing a deduction by both employer and employee in respect of the cash-out of options is applicable, the employer must not file the election if it wishes to claim the deduction. Instead, the employees will be deprived of a possible paragraph 110(1)(d) deduction.

IV. STOCK BONUS PLANS

A. Taxation of Immediate Bonus

At its simplest, a stock bonus is a bonus payable in the form of shares of the corporation. If the corporation intends to issue shares from treasury to the employee, the CRA views such an arrangement as an agreement to issue shares for purposes of section 7 of the ITA. A stock bonus can be a one-time incentive or an ongoing program that might provide, for example, annual stock bonuses. Pursuant to subsection 7(1), when the employee acquires the shares, the fair market value of the shares is required to be included in the employee's income as income from employment for the year. Because the employee pays no amount for the bonus shares, the paragraph 110(1)(d) deduction is not available. However, if the corporation is a CCPC, the income inclusion of the Section 7 Benefit is deferred until the year of disposition of the shares and a paragraph 110(1)(d.1) deduction would be available where the shares are held for at least two years. From the corporation's perspective, the issuance of shares by way of bonus to employees would not give rise to a corporate tax deduction.

B. Restricted Share Units Payable in Shares

A stock bonus can take the form of a restricted share unit plan. In this case, a restricted share unit ("RSU") would give the employee a right to receive a share of the capital stock of the corporation at a future date provided that certain conditions have been satisfied. Such conditions could include meeting performance targets either at the corporate level or at the individual level or both. Alternatively, the condition might simply be that the individual must remain an employee until the date specified for delivery of the shares.

Because the RSU plan provides for the issuance of shares by the corporation to the employee at a future date, section 7 again applies to the grant of RSUs. Accordingly, the grant of an RSU does

not give rise to immediate tax consequence to the employee. It is not until shares are issued to the employee that tax liability will arise. The fair market value of the shares issued to the employee will be income from employment to the employee in the year of issue. Again, except in the case of a CCPC plan, no paragraph 110(1)(d) deduction would be available since the employee pays nothing for the bonus shares. (See Appendix C.)

C. Comparison to a U.S. Restricted Share Plan

An RSU plan for Canadian employees is preferable to extending a U.S. parent corporation's restricted share program to Canada. The RSU plan is a reasonable proxy for the U.S. restricted share program without triggering the adverse tax consequences of the latter. Under a typical U.S. restricted share program, shares are issued at the outset but are subject to a number of restrictions. Until the restrictions lapse, the employee cannot deal freely with the shares. There is potential for forfeiture of the restricted shares. For U.S. tax purposes, generally speaking, the employee is not subject to tax on an award of restricted shares until such time as the restrictions have lapsed. By contrast, under Canadian tax rules, the employee would be taxed on the value of restricted shares at the time such shares are issued to the employee. The only relief is that the CRA will permit a reasonable discount from the fair market value of a share that is not subject to any restrictions in determining the value of the restricted share.³³

The RSU plan differs from the restricted share program in that the bonus shares are delivered at the end of the restriction period rather than at the beginning and only if the specified conditions have been satisfied. Until the shares are issued to the employee at the end of the period, the employee would not be required to report any amount in income. If shares are never issued because the conditions have not been satisfied, there is no tax consequence to the employee. By contrast, if restricted shares under a restricted share program are required to be forfeited by the employee, the employee would have had an income inclusion in the year the shares were issued and would be entitled to only a capital loss in the year of forfeiture. (See Appendix C.)

V. STOCK PURCHASE PLANS

Stock purchase plans are usually made available to the entire employee population or to a significant segment of the workforce, such as all full-time employees. Such plans come in a

variety of forms and sometimes involve trustees. At its most basic, a stock purchase plan is an agreement whereby the employer from time to time offers to sell shares to employees, usually for FMV purchase price.

In the case of a basic stock purchase plan where shares are offered at FMV, there is no Section 7 Benefit. The employee simply pays full value for the shares. Even though the full price is charged, such plans are attractive to employees because of the ease of investing and cost savings. Typically, employees may accumulate the purchase price for the shares through regular payroll deductions at an amount fixed by the employee at the start of the year. A change to the amount is usually permitted to be made during the year. The purchase of shares from treasury saves the employee brokerage costs. Like the purchase of Canada Savings Bonds through payroll deductions, a stock purchase plan offers a convenient and easy way for employees to save and, in this case, invest in shares of their employer.

If the stock purchase plan offers shares at a discount, the employee will realize a Section 7 Benefit equal to the amount of the discount from the FMV of the shares at the date of purchase. The availability of the paragraph 110(1)(d) deduction is unlikely, although the terms of the agreement should be examined for this possibility. No deduction may be taken by the employer in respect of the Section 7 Benefit.

A. Shares Sold at a Discount

While not typically offered in Canada, the discounted stock purchase plan seems to be a common type of employee stock incentive in the United States. Discounted plans that meet the requirements of section 423 of the *Internal Revenue Code* are given favourable U.S. tax treatment. The Canadian tax treatment of a section 423 plan needs to be considered where the plan is extended to Canadian employees. A typical section 423 plan might include the following provisions:

- The purchase price per share is equal to 85% of the lesser of the FMV of the share at the start of the offering period and the FMV of the share at the end of the offering period.
- The offering period is the calendar quarter, subject to variation by the corporation.

- All employees are eligible to participate, provided that, as of the first day of the offering period, they are customarily employed for more than 20 hours a week.
- On the first day of each offering period, the corporation grants to each eligible employee an option to purchase on the last day of the offering period at the purchase price up to a specified number of whole shares, and if the employee continues to be a participant on the last day of the offering period, the employee is deemed to have exercised the option on such date.
- Each eligible employee may authorize payroll deductions at a minimum of 1% up to a maximum of 10% (in whole percentages) of his or her compensation for each pay period. The payroll deductions are notionally credited to a book account for the employee maintained by the corporation. Typically, no interest is paid on payroll deductions.

This type of plan would constitute an agreement by the corporation to sell shares to an employee within the meaning of section 7. Accordingly, at the end of each offering period when shares are purchased for the employee, paragraph 7(1)(a) would deem the employee to receive a benefit from employment equal to the amount by which the FMV of the share on the date of purchase exceeds the purchase price. Care should be taken in determining the amount of the Section 7 Benefit. The amount of the benefit may not necessarily be simply the 15% discount from the FMV of the share at the date of purchase.

Example

FMV at start of offering period	\$ 9.00
FMV at end of offering period	\$10.00
Purchase price @ 85% x \$9	7.65
s. 7(1)(a) benefit	2.35

Because the 15% discount is applied to the lower start value to arrive at the purchase price, the Section 7 Benefit in this example amounts to 23.5% of the stock's FMV at the purchase date.

Where the purchase price for shares under a section 423 plan is set at a discount from the lower of FMV at the start and end of the offering period, there would never be an instance where the purchase price would be equal to or greater than the FMV of the share at the date of grant of the option (i.e., the commencement of the offering period) to purchase shares. Accordingly, in these circumstances, the employee would not be entitled to claim the 50% deduction under paragraph 110(1)(d).

B. Employee Savings Plans with Company Match

To encourage employees to invest in company stock, as well as to save for the future, some corporations will match the amounts contributed by the employee through payroll deductions. For example, employees might be permitted to contribute up to 6% of base pay (in whole percentages) by way of payroll deduction to the plan. The employer would then match the employee contributions at some specified rate, for example, 50%. Typically, a trust would be established in connection with the plan and the trustee would receive both employee and employer contributions and, on a monthly basis, apply the contributions to the purchase of shares for the accounts of the participating employees.

In the context of employee savings plans of this nature, the main tax issue is whether the employer could claim a deduction in respect of its contributions to the trustee. The answer depends on whether the plan constitutes an agreement by the corporation to sell or issue shares to the employee. If the trustee applies the employer contributions to the purchase of the shares from treasury, deductibility to the employer would likely be denied pursuant to paragraph 7(3)(b). In *The Queen v. Placer Dome Inc.*³⁴ the issue was whether the stock purchase plan was subject to section 5 or section 7. The plan involved employee contributions and matching employer contributions paid to a trustee who applied the cash to purchase shares of the employer. In the year in question, the trustee purchased shares issued from treasury. The employer had claimed a deduction for the matching contributions on the basis that they represented salary or wages paid to the employee for purposes of section 5 and reported as such on the T4 slips. The Minister denied the deduction under paragraph 7(3)(b) on the basis that the plan was an agreement to issue shares to employees. The court agreed, noting that there was no actual cash outlay by the corporation since its contributions were returned to it for the treasury shares. It was as though the corporation had simply issued shares at a one-third discount to the employees (i.e.,

each dollar of employee contributions was matched by 50¢ of employer money). The court held that the plan was governed by section 7, rather than section 5.

The result would have been different had the trustee used the employer contributions to purchase shares on the open market. In those circumstances, there would have been no agreement by the corporation to *sell* shares (as the shares would be purchased on the open market) or to *issue* shares (as no treasury shares would be issued). If an employee savings plan could be structured to involve only market purchases, the tax consequences to the employee of participation in the plan would be as follows:

- The employee would be taxed currently on both the employee's payroll deductions as well as the employer matching contributions. In essence, the monies going into the plan would be treated as the employee's after-tax salary, which is brought into income under section 5 of the ITA
- Any dividends earned in the plan for the account of the employee would be required to be included in the employee's income for the year, regardless of whether such dividends are distributed in the year to the employee. Likewise, any disposition by the plan trustee of shares from the employee's account would be treated as the employee's disposition for tax purposes.³⁵
- The employer would be entitled to claim a deduction for its cash contributions to the plan on the basis that such amounts constitute salary or wages to the employees which the employees have applied (through the trustee) to the purchase of shares on the open market.

Yet another way of structuring an employees savings plan of this nature would be the establishment of an "employees profit sharing plan", whereby the employer contributions are computed by reference to profits or made out of profits. The tax treatment of the employees and the employer is specified in section 144 of the ITA, but in essence would be the same as described immediately above. While subsection 144(5) provides that an employer contribution made in the year or within 120 days of the year is deductible by the corporation, the CRA has interpreted this to apply only if the shares were purchased on the open market. If treasury shares were purchased with the employer contributions, the CRA takes the position that the plan would

be governed by section 7, with the result that the corporation would be denied a deduction by virtue of paragraph 7(3)(b).³⁶

VI. PHANTOM STOCK PLANS

There may be circumstances in which real equity (i.e., actual shares) is unavailable or inappropriate for purposes of executive compensation. For example, the employer may be a wholly-owned subsidiary or, due to limits imposed under a stock incentive plan that is subject to stock exchange approval, no further shares are available for an employee share program. More recently, as the popularity of stock options has declined in response to corporate governance issues in the post-Enron era, employers are seeking alternatives.

In such cases, cash incentives based on stock value appear to be an attractive proxy for equity compensation. From the company's perspective, long-term incentives can operate as an effective retention device and, because the value to be delivered is tied to stock value, as a real incentive motivating enhanced performance by the employee. From the employee's standpoint, the grant of a cash incentive based on stock value can similarly motivate performance by creating the potential for a significant bonus at the end of the performance period. Certain phantom stock plans and deferred stock unit plans meet these objectives. However, such plans must be structured to avoid certain tax limitations.

A. Planning Around Tax Limitations

Given that many equity-based incentives are designed for the medium-term or the long-term, it is essential that income tax liability be deferred until the year that the value of the incentive is delivered to the individual, whether in cash or in kind.

In this regard, the particular incentive program must be designed to ensure that it does not fall within the SDA rules in the ITA and, in addition, does not give rise to a possible challenge by the CRA on the grounds of constructive receipt.

1. The SDA Rules

As noted at the outset, SDA is defined very broadly and could potentially apply to equity-based incentives such as phantom stock plans. There are a number of express exceptions listed in the SDA definition and the relevant ones for equity-based compensation, other than stock options and stock bonuses,³⁷ are found in paragraphs (k) and (l):

- (k) a plan or arrangement under which a taxpayer has a right to receive a bonus or similar payment in respect of services rendered by the taxpayer in a taxation year to be paid within 3 years following the end of the year; or
- (l) a prescribed plan or arrangement; . . .

Plans that qualify under paragraph (k) or (l) are not SDAs and, therefore, participants are generally not taxed until the benefit (usually cash) is in hand.

2. Constructive Receipt

The doctrine of constructive receipt is not well developed in Canadian jurisprudence.³⁸ The CRA, however, interprets the word “received” in the ITA³⁹ as referring to amounts constructively received as well as actually received. The CRA summarizes its views on constructive receipt as follows:

The department considers an amount to be received by an employee upon the earlier of the date upon which payment is made and the date upon which the employee has constructively received a payment. Constructive receipt is considered to occur in situations where an amount is credited to an employee's debt or account, set apart for the employee, or otherwise available to the employee without being subject to any restriction concerning its use. The situation is the same following termination of employment, retirement or death. An election to receive payment in instalments must be made before the amounts become available to the employee.⁴⁰

While this statement predates the enactment of the SDA rules, which would apply to the unfunded deferred compensation plans that prompted the question, constructive receipt remains of concern. Even if a particular incentive plan fits within an exception to the SDA definition, if the employee has the ability to call for payment prior to the date normally fixed for payment, the

CRA could well require the employee to include the amount in income in a year earlier than the year in which payment is actually received.

B. Designing The Phantom Stock Plan

A phantom stock plan is, in essence, a cash bonus program under which the amount of the bonus is commonly based on the value of the corporation's shares at the date of payment of the bonus. This type of share-based cash bonus program is variously called a phantom stock plan, a share appreciation rights plan, a restricted share unit plan and a deferred share unit plan, among other terms. It should be noted that none of these terms is a term of art, and it is necessary to examine the terms and conditions of a particular plan before commenting on the tax consequences.

Given that an award to an employee of phantom shares gives the employee a right in the year to receive a cash bonus after the year, the objective of a phantom stock plan is to design it in such a manner as to fall outside of the SDA definition.

1. The 3-year Restricted Share Unit

A cash-settled restricted share unit ("RSU") plan that provides for payment within three years is an increasingly popular medium-term incentive used by many corporations. For some corporations, the RSU plan has replaced stock options. These RSU plans are designed to fit within the 3-year deferral period for bonuses in paragraph (k) of the SDA definition (reproduced above) so that taxation of the award is deferred until cash is received. A typical RSU plan would have the following features:

- each RSU is a proxy for one share of the capital stock of the company and entitles the holder to receive the value of one share at the payment date;
- the annual bonus for services rendered in the year would be converted into a number of RSUs based on the fair market value of the share at the date of the award;

- the plan could provide for a mandatory conversion of the bonus to RSUs or permit the employee to elect the percentage of the bonus to be converted to RSUs, with the balance to be paid in cash;
- the RSUs credited to the employee's account in the plan could earn dividend equivalents in the form of additional RSUs when dividends are declared on the company's shares; and
- the RSUs referable to the particular bonus would be paid out in cash no later than December 31 of the third calendar year following the year in which the services were rendered.

Because the plan fits within an express exception in the SDA definition, the plan does not constitute an SDA. Thus, the employee is not taxed on the grant of the RSUs or on the crediting of any dividend equivalents; taxation occurs only when the employee receives a cash payment for the RSUs in his or her account. Care should be taken to ensure that the three year period is calculated from the end of the year in which the services were rendered, and not from the award date, which typically is two or three months following the year in question. A plan that provides for payment on the third anniversary of the award date may actually fall outside the three year period allowed in paragraph (k) of the SDA definition. The CRA is attuned to these timing differences.

An RSU plan differs from a share appreciation rights plan in that each RSU has immediate value at grant (i.e., equal to the fair market value of a share at the grant date). (See Appendix C.)

An RSU that has a term longer than 3 years would not fit within the paragraph (k) "safe harbour" but might still be exempt from the SDA rules if none of the main purposes was tax postponement or if there is a substantial risk of forfeiture. The CRA has issued a favourable advance tax ruling in respect of "performance stock units" that vested only if economic targets were met and were forfeited if such targets were not met.⁴¹ Based on more recent personal experience, however, this tax ruling may be an anomaly. The CRA has refused to rule on a RSU plan, the payout under which was to depend on a target return on equity over a three year period. Because the company in question had a calendar year fiscal period, and the payout, which depended on the financial statement for the third fiscal year could not be made until February or March of the fourth year, the plan missed the paragraph (k) 3 year cut-off by two or three months. The CRA

was unwilling to accept the company's arguments based on purpose and substantial risk of forfeiture.

2. *The Share Appreciation Rights ("SAR") Plan*

A phantom stock plan designed to deliver cash equal to the appreciation in share value over a period is potentially an SDA. If the SAR plan provides for payment within 3 years, it should fit within the paragraph (k) exception discussed above, provided that the SAR grant is a bonus for services rendered in a particular year.

However, if the time horizon for payment extends beyond three years following the service year, care must be taken in the design of the plan. Generally speaking, a SAR plan with the following attributes would not constitute an SDA:

- each SAR has a nil value at the date of grant;
- each SAR entitles the holder to receive the appreciation in value of one share of the capital stock of the company from the date of grant of the SAR to the date of payment; and
- payment is to be made at a fixed future date, with no ability for the holder to obtain payment at an earlier date. This restriction should eliminate any constructive receipt concern as well as SDA risk.⁴² Typically, a SAR has a set term, such as five years or seven years, at the end of which the amount of the bonus is determined based on the share appreciation during the term and paid out. The CRA has indicated that a phantom stock plan which provides a cash bonus based only on future appreciation in value would generally not be treated as an SDA, on the basis that the award is not for services already rendered but rather relates to future services.⁴³ (See Appendix C.)

C. Long-Term Deferred Share Units

The long-term deferred share unit ("DSU") plan is a form of phantom stock plan that is designed to fit within the express exception provided in paragraph (l) of the SDA definition. Paragraph (l) of the definition refers to a prescribed plan or arrangement. Regulation 6801(d) prescribes one

such arrangement that has given rise to the DSU plan, which has been implemented by many public corporations as an incentive/retention program for executives and directors.⁴⁴ The conditions that must be satisfied under Regulation 6801(d) are as follows:

- there is an arrangement in writing between the corporation and an employee under which the employee (or, after the employee's death, a dependant or relation or legal representative) may receive an amount that may reasonably be attributable to the employee's employment with the corporation;
- payments are deferred until the employee retires, dies or otherwise terminates employment and are made no later than the end of the first calendar year commencing after such time;
- the amounts which may be received under the plan depend on the FMV of the shares of the capital stock of the corporation or a related corporation at a time within the period that commences one year before the time of death, retirement or termination of employment and ends at the time the amount is received; and
- the employee or a person with whom the employee does not deal at arm's length is not entitled to be protected against any reduction in the value of the shares.

The DSU plan can be an incentive that is additional to the regular salary and bonus components of the compensation package. Alternatively, the DSU plan can be used as a means of deferring a portion of salary or bonus. For example, the employee may be provided the choice of receiving the annual bonus immediately or having all or a portion of the bonus converted into DSUs to be paid out in cash following termination of employment or retirement. The election to take cash or DSUs must be made prior to the date that the annual bonus becomes payable in order to avoid the risk of constructive receipt. The conversion of the bonus to DSUs would be based on the FMV of the company's shares at the date of conversion. Thus, a \$10,000 bonus would be converted into 100 DSUs if the trading price of a share happens to be \$100 at the date of conversion. Each DSU would entitle the employee to receive the value of one share of the company determined, typically, at the date of retirement or termination of employment. If the value of the company's shares has quadrupled during that time, the employee's 100 DSUs would

be worth \$40,000 at the payout date. The payout is most commonly in the form of cash, although some plans provide for the delivery of market-purchased shares.

To mimic share ownership, a DSU plan can provide for dividend equivalents. Thus, when dividends are paid on shares of the company, equivalent amounts can be credited on the DSUs held in the employee's account, and such amounts can, in turn, be converted into additional DSUs based on the fair market value of the shares at the date dividends are paid.

Because a DSU plan permits payment only after the employee's retirement or termination of employment for any other reason, the use of such plans has generally been reserved for directors of the corporation and senior management. Deferral of compensation for a potentially long period, particularly where there is risk of loss due to the fluctuation of share value, may not be attractive to employees at lower income levels or a long way from retirement. By comparison, senior executives and directors whose time horizon to retirement is shorter and who do not need the extra dollars currently may find a DSU plan a worthwhile deferral vehicle. (See Appendix C.)

From the corporation's perspective, a DSU plan can satisfy the dual objectives of incentive and retention. However, where the business is cyclical, as is the case with certain commodities, a corporation may find that the restraints on payout make the DSU plan problematic. As the stock price approaches the peak of the cycle, DSUs might actually provide an incentive for top executives to leave as it is only on employment termination that they can realize the value of their DSUs.

VII. INCOME TRUSTS – EQUITY INCENTIVES

A. Employee Options

While the focus of this paper is on corporations and their equity incentive plans, it is important to note that the tax rules described in sections A., B. and C. of Part III above apply equally to options granted by a mutual fund trust to its employees to acquire trust units. The initial extension of the rules in section 7 and paragraph 110(1)(d) to mutual fund trust options was announced in the 1998 federal budget “in order to provide a level playing field.” Pursuant to

subsection 132(6) of the ITA, a trust is a mutual fund trust at any time if at that time it was a unit trust resident in Canada that complied with prescribed conditions and whose only undertaking was:

- (i) the investing of its funds in property (other than real property),
- (ii) the acquiring, holding, maintaining, improving, leasing or managing of any real property that is capital property of the trust, or
- (iii) any combination of the activities described (i) and (ii) above.

Regulation 4801 sets out the prescribed conditions. In general terms, a prospectus, registration statement or similar document has been filed with a public authority in Canada in respect of a class of units of the trust and there has been a lawful distribution to the public of units of that class in accordance with that document or there has been a lawful distribution in a province to the public of units and a prospectus, registration statement or similar document was not required by provincial law. In addition, there must be at least 150 beneficiaries of the trust, each of whom holds not less than one block of units and units having an aggregate fair market value of not less than \$500.

Because the security under the option is a trust unit rather than a share of a corporation, the rules in section 7 and paragraph 110(1)(d) are modified in the following respects:

- The requirement in paragraph 110(1)(d) for shares to be “prescribed shares” does not apply; instead, trust units are simply required to be of a widely-held class of units of the mutual fund trust.
- Prior to Budget 2010, on exercise of an option, an employee of the mutual fund trust could elect to defer taxation of the Section 7 Benefit in the same manner as an employee of a public corporation and was subject to the same rules described in Appendix A; however, there were no comparable rules to the requirements for non-specified shareholder status or for listing of the share on a designated stock exchange. The Budget 2010 proposal to repeal

the deferral election, however, applies equally to mutual fund trust unit options exercised after 4:00 p.m. EST on March 4, 2010.

The federal government's announcement on October 31, 2006 to impose a distribution tax on income trusts commencing with the 2007 taxation year⁴⁵ ended the rush of then pending income trust conversions. The new tax applied as of 2007 to new "specified investment flow-through" (SIFT) trusts (or partnerships) but was deferred until 2011 for SIFTS that were publicly traded as of October 31, 2006. In light of the SIFT tax, which caused income trusts to consider converting to corporate form prior to 2011, there may not be much future for the trust unit option plan. However, for income trusts that intend to continue and certainly for real estate investment trusts ("REITS") that are excluded from the SIFT trust definition, the development of incentives based on trust units, rather than shares, remains important. The rules in Section 7 need to be reviewed in the design of any such plans.

More fundamentally, depending on which entity employs the employees the question is whether an employee trust unit option plan is even feasible. For example, a typical income trust structure involves putting the operating company beneath the income trust (i.e., the income trust would be a shareholder), with the employees continuing to be employed by the corporation. If there are other shareholders, such that the income trust does not control the corporation, any options granted by the trust to those employees would not qualify under section 7. Section 7 applies to an option granted by a mutual fund trust to its own employees or the employees of a corporation with which it does not deal at arm's length. For this purpose, subsection 7(1.11) provides that a mutual fund trust is deemed not to deal at arm's length with a corporation only if the trust controls the corporation.

B. Other Equity-Based Plans

In the income trust structure, in addition to a trust unit option plan, there is a need to implement or replicate the other common medium-term and long-term equity incentives. Fortunately, most of the stock-based incentives can be replicated based on the trust unit; however, depending on the type of incentive, certain exemptions available to stock-based plans may not be available, and modifications are required. The following plans utilizing trust units or based on the value of trust units might be considered.

1. The Deferred Trust Unit

The deferred trust unit (“DTU”) plan for trustees and executives is intended to replace the former deferred share unit plan for directors and executives. As noted above, the DSU Plan is typically designed to fit within the “prescribed plan” exception to the SDA rules, as set out in Regulation 6801(d). In a typical DSU Plan, an individual’s DSUs are normally settled in cash following the individual’s retirement or other termination of employment. In the case of a DTU Plan offered by an income trust, however, settlement cannot be restricted to cash because Regulation 6801(d) is applicable only to plans where the amount to be received “depends on the fair market value of *shares of the stock of the corporation* or a corporation related thereto.” [emphasis added] Thus, notwithstanding that the amount to be received will depend on the value of publicly-traded trust units, the individual cannot rely upon Regulation 6801(d) to exempt the DTUs under a cash plan from immediate taxation under the SDA rules.

To achieve deferral of taxation until retirement or other termination of employment, the DTU Plan must be structured to provide for payment in the form of newly-issued trust units. If an income trust will be issuing trust units to an executive or trustee in settlement of the DTUs following termination of employment, the DTU Plan will fall within the ambit of section 7 of the ITA as an agreement to issue securities. By virtue of paragraph 7(3)(a), an agreement to sell or issues securities will be taxed only in accordance with section 7, thus precluding the operation of the SDA rules.

2. The Restricted Trust Unit

As in the case of corporate restricted share unit (“RSU”) plans, an income trust may also offer a couple of different types of restricted trust unit (“RTU”) plans. The first is a bonus plan that is payable in the form of newly-issued trust units. Such a plan would fit within section 7 as an agreement to issue securities. This type of bonus plan has no time restrictions, other than what might be imposed under stock exchange rules. In other words, the plan could provide for settlement of the individual’s RTUs with newly-issued trust units beyond the 3-year limit found in the paragraph (k) exception in the SDA definition. For example, an RTU plan could provide for RTUs to vest on the third, fourth and fifth anniversaries of the date of grant, with trust units to be issued upon vesting.

The other form of RTU Plan is a cash bonus plan that is based on the value of trust units. As in the case of a corporate RSU Plan that is settled in cash, such a plan must be designed to fit within the paragraph (k) 3-year exception contained in the SDA definition.

3. Trust Unit Purchase Plans

The same considerations described above for employee share purchase plans apply also to employee trust unit purchase plans. An income trust that in its prior corporate incarnation had an employee share purchase plan could readily change that plan to an employee trust unit purchase plan. For example, if the prior plan was structured as an employees profit sharing plan under section 144 of the ITA, the new plan could similarly qualify. The only difference, of course, is that the employee and employer contributions are used by the trustee to purchase trust units rather than shares.

In summary, most of the equity incentives employed within the corporate context translate fairly readily into the income trust context. From the employees' standpoint, however, depending on how the stock had performed when the employer was a corporation and the forecast for the income trust, the economics of an incentive based on trust units may be perceived to be different from the economics of a stock-based incentive.

VIII. CONCLUSION

As discussed in this paper, equity-based incentives can take a variety of different forms and only the more common plans have been canvassed herein. The tax treatment of the individual and the employer will depend upon the type of incentive plan under consideration. Some of the tax rules are quite complex, as illustrated by the history of public company stock options. Moreover, as the business environment changes, we may expect to see new variations in equity incentive plans. Increasingly, corporations and executives look to tax lawyers to assist them with the design, negotiation and amendment of their equity incentives, as well as with tax disputes. Familiarity with the basic tax framework for equity incentives is essential to the task of providing sound tax advice.

April 15, 2010

APPENDIX A

The Deferral Election for Public Corporation Stock Options

The rules brought in by the 2000 federal budget to provide deferral for employees exercising options on publicly-listed shares were quite complex. To benefit from the “tax break”, the employee’s share acquisition had to be a “qualifying acquisition”, and the employee had to file an election. The following summarizes the existing rules which, as a result of Budget 2010, will no longer apply to options exercised after 4:00 p.m. EST on March 4, 2010. However, certain of the following rules, such as the annual reporting requirements, continue to be relevant to shares for which a deferral election was previously filed (i.e., prior to March 4, 2010).

1. Qualifying Acquisition

Pursuant to subsection 7(9), an employee’s acquisition of a share is a “qualifying acquisition” eligible for the deferral if the following conditions are met:⁴⁶

- (a) the share is acquired after February 27, 2000. It does not matter that the option was granted before February 28, 2000, so long as the option is exercised after February 27, 2000;
- (b) the employee would otherwise be entitled to the deduction in paragraph 110(1)(d);
- (c) the employee was not, immediately after the option was granted, a “specified shareholder” of (i) the corporation granting the option, (ii) the corporation that was the employee’s employer and that was not dealing at arm’s length with the granting corporation and (iii) the corporation whose shares could be acquired under the option. Generally, a “specified shareholder” is a shareholder who owns (directly or indirectly) 10% or more of the shares of any class of the relevant corporation, or of a corporation related to the relevant corporation;⁴⁷ and
- (d) the shares must be of a class listed on a designated stock exchange at the time the shares are acquired.⁴⁸

2. *The Deferral Election*

To obtain the deferral described above, an employee is required by subsection 7(10) to file an election before January 16th of the year following the year in which shares are acquired. The election must be filed in prescribed form and manner with a person who will be required to report the deferred employment benefit (usually the employer)⁴⁹ and must contain the following information:

- confirmation that the employee was a resident of Canada at the time the share was acquired,⁵⁰
- confirmation that the \$100,000 annual vesting limit has not been exceeded,⁵¹ and
- the amount of the benefit related to qualifying shares acquired under the option agreement that the employee wishes to defer.

3. *\$100,000 Annual Vesting Limit*

The “specified value” of all shares under options vesting in the same year and in respect of which deferral is elected cannot exceed the annual vesting limit of \$100,000. The annual limit applies to options granted under all stock option plans in which the employee participates. Generally, the “specified value” of a share is the FMV of the share at the time the option was granted, subject to adjustment for modifications to the number or type of shares subsequent to the date of grant (e.g., to account for stock splits).⁵² Since the specified value is determined using the FMV at the date of grant, not at the date of exercise, the actual amount of the Section 7 Benefit available to be deferred will likely be a different number than \$100,000 (since the Section 7 Benefit is the excess of the FMV of the share at the date of exercise over its FMV at the date of grant). If the employee has different options vesting (i.e., becoming exercisable) in a single year for shares with a FMV on the date of grant in excess of the \$100,000 annual limit, the employee can choose those options for which the deferral will be claimed.

The responsibility for compliance with the annual limit rests with the employee. Consequently, employees will need to keep track of which year each grant of options vests, the number of

shares available under those options, and the value of those shares on the date the option was granted in order to ensure that they have complied with the \$100,000 annual vesting limit.

4. Ordering Rules

If the employee has identical options (i.e., each option is a right to acquire the same number of shares at the same exercise price), subsection 7(12) sets out an ordering rule for determining which of the identical options has been exercised. The employee can designate which options have been exercised.⁵³ By designating the exercise order, the employee can make maximum use of the \$100,000 annual vesting limit. If the employee does not make a designation, identical options are deemed to be exercised in the order in which they first became exercisable. If identical options vest at the same time, the options are deemed to be exercised in the order in which they were granted.⁵⁴

Example

In 2006, Dale receives two option grants, each for 75,000 shares at an exercise price of \$2/share (i.e., the FMV at the grant dates).

Grant #1 vests in 2007. Grant #2 vests in 2008.

In January 2009, FMV of a share is \$7. Dale acquires 75,000 shares for \$2 each for a Section 7 Benefit of \$375,000 (75,000 x (7-2)).

Dale can elect to defer the entire \$375,000 Section 7 Benefit by designating 50,000 shares under Grant #1 which vested in 2007 (specified value of \$100,000) and 25,000 shares under Grant #2 which vested in 2008 (specified value of \$50,000).

If no subsection 7(12) designation is made, all 75,000 shares would be deemed to have been acquired under Grant #1. Because of the annual vesting limit of \$100,000, Dale would be able to elect deferral only in respect of 50,000 shares (i.e., Section 7 Benefit of \$250,000) and would have an immediate income inclusion in respect of 25,000 shares (i.e., Section 7 Benefit of \$125,000).

Subsection 7(1.3) establishes an order for the disposition of identical shares. Such a rule is needed for the purpose of determining when deferral shares have been disposed of and, consequently, when the deferred Section 7 Benefit is to be included in the employee's income. Subsection 7(1.3) deems identical shares to be disposed of in the order in which they were

acquired (i.e., first in, first out). For this purpose, when the employee acquires a non-deferral share at a time when he or she holds a deferral share, the non-deferral share is deemed to have been acquired first. Thus, on a disposition of shares, the employee is considered to have disposed of shares that were not subject to deferral pursuant to subsection 7(1.1) (for CCPC shares) or 7(8) (for publicly-listed shares) before shares for which a deferral has been allowed.⁵⁵ This is advantageous to employees as it maximizes the deferral period and, in addition, in the case of CCPC shares, enables the employee to determine whether the two-year hold requirement for purposes of the paragraph 110(1)(d.1) deduction has been met. If the employee acquires a number of identical deferral shares at one time, the shares are deemed to have been acquired in the order in which the related options were granted.⁵⁶

The ordering rule in subsection 7(1.3) is modified in the situation where the taxpayer disposes of shares within 30 days of acquiring identical shares and no other such shares were acquired or disposed of in that period. Subsection 7(1.31) permits the taxpayer to identify the newly acquired shares as the shares which were disposed of. As discussed below, this provision is of significant benefit to the employee in calculating the amount of gain on the disposition.

5. Adjusted Cost Base of Stock Option Shares

In the year of disposition of stock option shares, the employee will be responsible for calculating and reporting the capital gain or loss and will need to know the adjusted cost base (“ACB”) of his shares. Several rules apply to the determination of the ACB of stock option shares. By way of background, shares of the same class of capital stock owned by a taxpayer are identical properties, and the ACB of an identical property to the taxpayer at any time is generally equal to the average cost of all identical properties held at that time.⁵⁷ If the taxpayer bought 100 shares of a corporation at \$10 each (\$1,000) and another 200 shares of the same class later at \$25 each (\$5,000), the ACB for the 300 shares would be \$6,000 and the ACB for each share would be \$20 ($\$6,000 \div 300$).

A further ACB rule applies to shares acquired under a stock option. Paragraph 53(1)(j) of the ITA increases the ACB of stock option shares by the amount of the Section 7 Benefit. In the preceding example, if the 200 shares were acquired for \$25 each on a stock option exercise when the FMV was \$40, the \$15 Section 7 Benefit would be added to the \$20 ACB of the stock option

shares for a total ACB of \$35 per share. The paragraph 53(1)(j) adjustment is not averaged over all 300 shares, with the result that the ACB of the original 100 shares will continue to be \$20.⁵⁸

Upon the taxpayer's sale of the stock option shares, the CRA previously took the position that, due to the fungible nature of shares, the taxpayer is treated as having disposed of a *pro-rata* number of shares from each of the two pools.⁵⁹

In conjunction with the rules implementing deferral in respect of public company stock options, the cost-averaging rule was modified. Subsection 47(3) significantly changes the determination of the ACB of identical shares. Basically, shares in respect of which deferral is in effect are deemed not to be identical to any other shares owned by the employee. In addition, shares disposed within 30 days of a stock option exercise and specifically identified under new subsection 7(1.31) are deemed not to be identical to any other shares. In other words, deferral shares and subsection 7(1.31) shares each have their own unique ACB.

Using the example above, if the employee sold the 200 stock option shares at \$40 each immediately following their purchase and specifically identified such shares under new subsection 7(1.31), chart 1 shows the tax consequences under the CRA's former position and chart 2 reflects the revised ACB rules:

Chart 1

Under the CRA's former position, the disposition of the 200 shares is required to be allocated on a *pro-rata* basis between the two pools in proportion to the 300 total shares, as follows:

	<u>Pool 1</u>	<u>Pool 2</u>	<u>Total</u>
Allocation of 200 Shares	$(200 \div 300) \times 100 = 66$	$(200 \div 300) \times 200 = 134$	200
Sale proceeds	66 @ \$40 = \$2,640	134 @ \$40 = \$5,360	\$8,000
Minus ACB	<u>66 @ \$20 = (\$1,320)</u>	<u>134 @ \$35 = (\$4,690)</u>	<u>(\$6,010)</u>
Capital gain	\$1,320	\$670	\$1,990
Taxable capital gain @ 50%			\$995
Section 7 Benefit			\$3,000
Minus stock option deduction			<u>(\$1,500)</u>
Taxable income			\$2,495
ACB of remaining 100 shares	34 @ \$20 = \$680	66 @ \$35 = \$2,310	\$2,990

Chart 2

Under the revised rules, if the employee specifically identifies the 200 stock option shares as the ones that were immediately sold, then the taxable income is calculated as follows:

	<u>Pool 1</u>	<u>Pool 2</u>	<u>Total</u>
Sale proceeds		200 @ \$40 = \$8,000	\$8,000
Minus ACB ⁶⁰		<u>200 @ \$40 = (\$8,000)</u>	<u>(\$8,000)</u>
Capital gain		\$0	\$0
Taxable capital gain @ 50%			\$0
Section 7 Benefit			\$3,000
Minus stock option deduction			<u>(\$1,500)</u>
Taxable income			\$1,500
ACB of remaining 100 shares	100 @ \$10 = \$1,000		\$1,000

As a result, the employee’s taxable income is reduced by \$995.00 for the year of disposition of the 200 stock option shares.

6. Annual Reporting Requirements

Upon receipt of an employee’s deferral election for a year, the employer will report, on the T4 slip issued to the employee for the taxation year of option exercise, the amount of the Section 7 Benefit to be deferred and the amount of the Section 7 Benefit to be taxed in the year. Thereafter, the employer shall have no further monitoring or reporting obligations in respect of the particular deferral. The employee will be responsible for reporting a particular deferred Section 7 Benefit in the year that the employee disposes of the underlying shares.

Employees with deferred benefits must also annually file a prescribed form, Form T1212 *Statement of Deferred Stock Option Benefits*, setting out information on the employee’s acquisitions and dispositions of stock option securities.⁶¹ Form T1212 has been designed to assist employees (and the CRA) in keeping track of the employee’s deferred employment benefits. Form T1212 must be filed with the employee’s personal income tax return for each year during which he or she has an outstanding balance of deferred employment benefits. This form must be filed regardless of whether or not the employee has deferred any employment benefits or

disposed of any securities relating to a deferred employment benefit in the taxation year for which the return is being filed.

APPENDIX B

Special Relief for pre-March 4, 2010 Deferred Stock Option Benefits

Example

Stock option exercise – March 1, 2008

FMV per share	\$80
Exercise price	\$20
Number of shares purchased	1,200
Total FMV of purchased shares	\$96,000
Less: exercise price	(\$24,000)
s. 7 Benefit deferred by election	\$72,000
ACB of shares	\$96,000

Sale of 1,200 shares – April 1, 2010

FMV per share	\$10
Proceeds of Disposition	\$12,000 B

Tax Consequences for 2010	Assume no election	Assume election filed
Include s. 7 Benefit in income	\$72,000	\$72,000
Less: para. 110(1)(d) deduction	(\$36,000)	
Less: deduction equal to s. 7 Benefit		<u>(\$72,000)</u>
Net income inclusion	\$36,000 A	0
Tax on A (@ 46%) / Special Tax (equal to B) ¹	\$16,560	\$12,000
Calculation of loss		
Proceeds of sale	\$12,000	\$12,000
Less: ACB of shares sold	<u>(\$96,000)</u>	<u>(\$96,000)</u>
Capital loss	(\$84,000)	(\$84,000)
Allowable capital loss	(\$42,000)	(\$42,000)
Net taxable capital gain*		<u>\$36,000</u>
Revised net capital loss	<u>(\$42,000)</u>	<u>(\$6,000)</u>

* Net taxable capital gain is 50% of lesser of:

- (i) deduction equal to s. 7 Benefit, i.e., \$72,000
- (ii) capital loss on sale, i.e., \$84,000

50% of lesser of (i) and (ii) is \$36,000 which is included in the taxpayer's income as a taxable capital gain for the year.

1. In the case of a Quebec resident, the special tax is equal to $\frac{2}{3}$ of the proceeds of disposition.

APPENDIX C

Alternatives to Stock Options: Restricted Shares, RSUs, DSUs

Definitions (general)

Stock option:	A right granted to an employee to purchase a fixed number of shares of the corporation at a fixed price over a specified term; the exercise right may be subject to vesting conditions.
Restricted share:	A share given to an employee, subject to a restriction on the employee's ability to freely deal with the share for a period of time; share could be subject to forfeiture in certain circumstances prior to vesting.
Restricted share unit (RSU)*:	A right granted to an employee to receive the value of one share at a fixed future date(s); RSUs are typically used to defer the annual bonus; RSU could be subject to forfeiture in certain circumstances prior to vesting.
Deferred share unit (DSU)*:	A right granted to an employee to receive the value of one share on death, retirement or termination of employment; DSUs are typically used to defer director's fees and executive bonuses; DSUs are generally not subject to forfeiture.
Stock Appreciation Right (SAR):	A right given to an employee to receive a payment equal to the appreciation (if any) in the stock price; may be granted in tandem with an option, such that an exercise of one cancels an equivalent portion of the other.

*** Caution: these terms are sometimes used interchangeably by clients.**

A FEDERAL TAX COMPARISON

	Stock Options (with or without SARs)	Restricted Shares	RSUs	DSUs
Grant	<ul style="list-style-type: none"> – not taxable event 	<ul style="list-style-type: none"> – taxable benefit = fmV of shares – taxed at full rates – CRA accepts value can be discounted because of restriction 	<ul style="list-style-type: none"> – not taxable event, provided plan properly structured (see Exercise/Settlement) 	<ul style="list-style-type: none"> – not taxable event, provided plan meets ITA Reg. 6801(d) conditions
Vesting	<ul style="list-style-type: none"> – not taxable event 	<ul style="list-style-type: none"> – not taxable event; usually shares are released on vesting 	<ul style="list-style-type: none"> – not taxable event 	<ul style="list-style-type: none"> – not taxable event
Dividends or Equivalents	N/A	<ul style="list-style-type: none"> – dividends received on shares are taxed to employee as dividend income 	<ul style="list-style-type: none"> – when dividends are paid, dividend equivalents may be credited on RSUs in employee's account – dividend equivalents may be converted into additional RSUs based on fmV of share at time of dividend – not taxable if book entry only – if plan provides for cash payment, payment is employment income and taxed on receipt 	<ul style="list-style-type: none"> – if plan provides for dividend equivalents, amounts must be converted into DSUs and credited to employee's account – no payments can be made to employee prior to death, retirement or termination of employment
Exercise/ Settlement	<p>A. Exercise of Option</p> <ul style="list-style-type: none"> – taxable benefit = fmV of share – exercise price – potential for 50% deduction in computing taxable income, i.e., resulting in tax on benefit at capital gains rates – potential for deferral of tax if company is CCPC at date of grant <p>B. Exercise of tandem SAR for</p>	N/A	<ul style="list-style-type: none"> – taxable benefit = cash or fmV of shares at settlement, provided settlement timed properly – taxed at full rates – timing of settlement depends on form of settlement provided in plan: A. newly-issued shares only – no time limit for settling/paying out shares (e.g., RSUs to be redeemed and shares issued on the 4th, 5th and 6th anniversaries of 	<ul style="list-style-type: none"> – to meet ITA Reg. 6801(d) conditions, settlement must be after death, retirement or termination of employment and no later than end of next calendar year – cash or fmV of shares included in income as employment income – taxed at full rates

	Stock Options (with or without SARs)	Restricted Shares	RSUs	DSUs
	<p>cash payment</p> <ul style="list-style-type: none"> – same taxable benefit and potential for 50% deduction as above where related stock option is cancelled* – because cash is paid, no tax deferral available 		<p>grant)</p> <p>B. cash or shares purchased on open market</p> <ul style="list-style-type: none"> – time limit for delivery of cash/shares is December 31 of 3rd calendar year following year for which RSUs were granted – if plan provides for payment past this limit, serious risk that plan will be “salary deferral arrangement” under ITA and fmV of RSUs will be taxed at grant 	
Forfeiture	<ul style="list-style-type: none"> – no consequence 	<ul style="list-style-type: none"> – disposition of shares for nil proceeds – employee will realize capital loss, which is deductible only against capital gains – bad result because employee was taxed in year of grant at full rates on share that is never released to him/her 	<ul style="list-style-type: none"> – no consequence 	<ul style="list-style-type: none"> – no consequence, although forfeiture is not a usual term of DSU plans
Deduction to Company	<ul style="list-style-type: none"> – no deduction for shares issued – deduction for cash paid* 	<ul style="list-style-type: none"> – no deduction for shares issued 	<ul style="list-style-type: none"> – no deduction for shares issued – deduction if cash paid or used to purchase market shares 	<ul style="list-style-type: none"> – no deduction for shares issued – deduction if cash paid or used to purchase market shares

* Budget 2010 proposes to eliminate the paragraph 110(1)(d) deduction on a cash-out of options unless the employer elects to forgo the corporate tax deduction.

ENDNOTES

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- ¹ RSC 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the “ITA”. Unless otherwise stated, statutory references herein are to the ITA.
- ² See definition in subsection 248(1).
- ³ See paragraph (j) of the definition of SDA in subsection 248(1) for the exception for a professional athletes’ arrangement.
- ⁴ In very general terms, a CCPC is defined in subsection 125(7) as a private Canadian corporation that is not controlled, directly or indirectly in any manner whatever, by one or more non-resident persons, by one or more public corporations, or by any combination thereof.
- ⁵ Section 7 is not restricted to stock option agreements. Because it refers to an agreement to sell or issue shares, section 7 also applies to stock purchase plans and stock bonus plans under which bonuses are paid in the form of shares issued from treasury.
- ⁶ Paragraph 7(3)(a) ensures that the employee is taxed only in accordance with section 7 when a corporation has agreed to sell or issue shares to the employee. Paragraph 7(3)(a) effectively precludes the application of the rules governing the “salary deferral arrangement”.
- ⁷ “Adjusted cost base” is defined in section 54; section 53 sets out adjustments to the cost of an asset to arrive at its adjusted cost base. Paragraph 53(1)(j) adds the amount of the Section 7 Benefit to the cost of the shares.
- ⁸ “Capital property” is defined in section 54 as any depreciable property and any other property the gain or loss from the disposition of which would be a capital gain or a capital loss.
- ⁹ See section 47.
- ¹⁰ For purposes of the ITA, a disposition includes events other than a sale for consideration. For example, a taxpayer is deemed to have received fair market value (FMV) proceeds on a gift of property. Furthermore, a taxpayer is generally deemed to have disposed of capital property immediately before death for proceeds equal to the property’s FMV at that time.
- ¹¹ To illustrate the difference in rates between salary (ordinary income) and capital gains, the combined federal/provincial marginal rate in 2010 for an Ontario taxpayer in the top tax bracket is 46.41% for salary income and 23.21% on capital gains.
- ¹² See paragraph 111(1)(b) for the carryover of net capital losses.
- ¹³ Paragraph 7(3)(b) prohibits a deduction to any person for a benefit “conferred on the employee by the sale or issue of the securities” to the employee.
- ¹⁴ The 1998 federal budget extended the section 7 treatment to the employees of mutual fund trusts who receive options to acquire trust units.
- ¹⁵ Subsection 6204(1) of the Regulations defines “prescribed share”. Among other factors, there are no maximum or minimum limits set on dividends that may be declared and paid on the share; there is no maximum or minimum amount that the shareholder is entitled to receive on liquidation of the corporation; the share generally cannot be converted into another security; the holder cannot at any time cause the redemption, acquisition or cancellation of the share by the corporation or related person; and the corporation or related person cannot reasonably be expected to, within 2 years, redeem, acquire or cancel the share or reduce its paid up capital. But see subsection 6204(2) for modifications.
- ¹⁶ The reduction to zero of the taxable benefit and the capital gains inclusion rate was implemented by the 2006 federal budget in respect of gifts to qualified donees other than private foundations. In the 2007 federal budget, the tax-free capital gain rule was extended to donations of publicly listed securities to private foundations.
- ¹⁷ See subsection 7(1.1).
- ¹⁸ See paragraph 110(1)(d.1).
- ¹⁹ See paragraph 14 of *Interpretation Bulletin IT-113R4* (dated August 7, 1996) “*Benefits to Employees – Stock Options*”.
- ²⁰ For a detailed CRA Q&A under the heading “Deferral of Taxation on Employee Stock Options”, see news release of February 26, 2001 (amended March 6, 2001), document 2001-02-26 on Tax Partner.
- ²¹ Subsection 7(8).
- ²² As noted in an article by Monica Gutschi on Dow Jones Newswires (March 15, 2010), the relieving rules “were mainly intended to remove a huge tax burden from a group of IT executives blindsided by the 2001 technology crash.” Of course, the relieving rules are of general application and are not limited to any particular sector.

23 As the deferral in respect of CCPC options is automatic, CCPC employees sustaining similar losses in share
value do not benefit from the budget measures.

24 The CRA's administrative position has been articulated at several "Revenue Canada Round Tables" at the
annual conference of the Canadian Tax Foundation. See 1983 Conference Report (Toronto: Canadian Tax
Foundation, 1984), 760-799, at 772-4; 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989),
53:1-188, Question 74, at 53:68-9; and 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992),
50:1-83, Question 47, at 50:28-9.

25 Subsection 7(1.5) provides similar rollover treatment for shares acquired under a CCPC stock option plan.
26 Of course, before proceeding with an exchange of options, it would be necessary to ensure that such exchange
complies with the rules of the particular stock exchange and would also be in conformity with any applicable
corporate laws.

27 The new provisions were included in draft legislation originally released on July 18, 2005 and was part of Bill
C-10, which received second Senate reading on December 4, 2007. Bill C-10 contained the non-resident trust
and foreign investment entity rules as well as the controversial film credit rules. Following the federal election
in October, 2008, the bill has yet to be re-introduced.

28 See Jonathan D. Glater, "Stock Options Are Adjusted After Many Share Prices Fall", The New York Times
(March 27, 2009).

29 90 DTC 6603 (FCA); leave to appeal to the Supreme Court of Canada refused June 20, 1991.
30 83 DTC 5110 (FC-TD).

31 See CRA document number 2000-0048355, November 14, 2000.
32 2008 DTC 2043(TCC). The Crown has not appealed Bowman C.J.'s decision.

33 For example, based on discussions with the Toronto Central Tax Services Office, Valuation Section, it appears
that a discount in the range of 10% to 20% would generally be acceptable in the case of a 2 to 3 year holding
period restriction.

34 92 DTC 6402 (FCA) overturning 91 DTC 5261 (FCTD).

35 Subsection 75(2) would apply, unless the plan were structured as an employees profit sharing plan.

36 See *Interpretation Bulletin IT-280R* (June 26, 1995) "Employees Profit Sharing Plans - Payment Computed by
Reference to Profits," paragraph 13.

37 As noted earlier, stock options and stock bonuses generally constitute agreements to sell or issue shares and
thus fall within section 7. Paragraph 7(3)(a) effectively precludes the application of the SDA rules.

38 See B.J. Arnold, *Timing and Income Taxation: The Principles for Income Measurement for Tax Purposes*,
Canadian Tax Paper No. 71 (Toronto: Canadian Tax Foundation, 1983), 90-95.

39 For example, as noted at the outset, subsection 5(1) states that "a taxpayer's income for a taxation year from an
office of employment is the salary, wages and other remuneration, including gratuities, *received* by the
taxpayer in the year".

40 See "Revenue Canada Round Table", in *Report of Proceedings of the Thirty-sixth Tax Conference*, 1984
Conference Report (Toronto: Canadian Tax Foundation, 1985) 783-847, Question 13, at 794-95. The particular
question to which the CRA responded is: "What is the department's current position with respect to
constructive receipt in the case of unfunded deferred compensation plans? Is the position the same following
termination of employment, retirement or death, where the employee may elect to receive payment as a lump
sum or in instalments?"

41 See CRA document # 2003-0051351R3.

42 See Advance Tax Ruling ATR-45 (dated February 17, 1992) which dealt with a share appreciation rights plan.
The plan provided for 3 retention periods. During the first two periods, units were redeemable only in certain
events (e.g., death, retirement). In the third period the employee "may redeem . . . at any time." The CRA
ruled that the plan was not an SDA at the end of the second retention period but declined to rule with respect to
the third period. See also CRA document # 2006-0201541R3, a ruling on a SAR plan.

43 See Question 26 of the "Revenue Canada Round Table", *Report of Proceedings of the Fortieth Tax
Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989) 53:1 at 53:44.

44 The CRA has issued numerous advance tax rulings for DSU plans, e.g., CRA documents #2009-0329411R3,
#2008-0271191R3 and #2007-0259371R3.

45 Bill C-52, containing the new tax on "specified investment flow-through trusts", received Royal Assent on
June 22, 2007. For income trusts that began trading after October 31, 2006, the tax applies beginning with
their 2007 taxation year. For pre-existing trusts, the tax will apply commencing with their 2011 taxation year,
provided that they do not grow in excess of specific guidelines set out by the federal government.

46 The deferral is available also to options granted by mutual fund trusts to employees to acquire trust units.

47 See the definition of "specified shareholder" in subsection 248(1).

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- 48 See definition in subsection 248(1) and the Minister of Finance's authority to designate a stock exchange in
subsection 262, added by 2007 Budget bill, effective December 14, 2007. The current Designated Stock
Exchanges include all former prescribed stock exchanges listed in repealed ITA Regulations 3200 (Canadian)
and 3201 (foreign).
- 49 Paragraph 7(10)(a). Under Regulation 200(5), the employer, the entity granting the option, and the entity
whose security is acquired under the option will be jointly liable for reporting the deferred employment benefit,
though it need be reported only by one of them. The deferred employment benefit is reported as a special
memo item on a T4 slip in the year in which the security is acquired.
- 50 Paragraph 7(10)(b).
- 51 Paragraph 7(10)(c).
- 52 Amount B in the formula in subsection 7(11).
- 53 Paragraph 7(12)(a).
- 54 Paragraph 7(12)(b).
- 55 Paragraph 7(1.3)(a).
- 56 Paragraph 7(1.3)(b).
- 57 Subsection 47(1).
- 58 See CRA document #2000-0035415
- 59 See *Income Tax Technical News No. 19* dated June 16, 2000.
- 60 Because subsection 47(3) deems these shares that are specifically identified under subsection 7(1.31) not to be
identical with any other shares, the ACB to the employee is equal to the price paid (\$25) plus the paragraph
53(1)(j) adjustment for the Section 7 Benefit (\$15).
- 61 Subsection 7(16). All prescribed forms are available on the CRA website: www.cra-arc.gc.ca.