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Employee stock options: do we have an agreement?

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In the fall of 2015, the Liberal government threatened to end the preferential tax treatment for certain employee stock options. But after much opposition, Finance Minister Morneau eventually backed off. In 2016, the Canada Revenue Agency issued comments on those rules, following up on the Tax Court's decision in *Transalta v. The Queen* (2012 TCC 86).

Employee stock option rules

The rules for taxing employee benefits arising from an agreement to acquire shares or mutual fund units of an employer are found in section 7 of the *Income Tax Act*. In general terms, the rules state that no benefit arises when options or rights are granted to employees; the benefit is determined when shares are actually acquired or the rights are otherwise disposed of for consideration. Where securities are issued, the benefit is computed at the time of exercise as the excess of the share value over the exercise price paid by the employee. The employee is entitled to claim a separate 50 per cent stock option deduction, provided certain conditions are met: the shares must be prescribed shares (generally, straightforward common shares), and the exercise price paid by the employee must be equal to or greater than the value of the shares at the time the rights were granted. Generally, tax must be withheld on these benefits, which often requires an immediate sale of some of the shares to fund the tax.

For Canadian-controlled private corporations (CCPCs), the 50 per cent deduction is also available to employees if the shares are owned for at least two years before disposition. The benefit arising from CCPC shares is computed at exercise but taxation is deferred until the shares are sold. No source withholding of tax is required in respect of CCPC stock option benefits.

Gains accruing after share issuance will generally be treated as capital gains. For CCPC shares, the holder may be eligible to claim the lifetime capital gains deduction to shelter capital gains (but not the stock option benefit), provided the various other requirements to claim the deduction are satisfied, including a minimum level of active business assets in the corporation and a two-year holding period for the subject shares.

Employer deductions

Generally, employers are denied a deduction for the cost of the securities issued to employees where section 7 applies. If the corporation pays cash to acquire the rights, other than pursuant to a takeover scenario, the payment is generally deductible, though the employee will be denied the 50 per cent deduction. However, the employer generally may elect to forego deducting the payment, which restores the employee's deduction.

The *Transalta* decision

Section 7 states that the various rules apply only where there is an agreement for the issuance of the shares. In *Transalta*, the Tax Court confirmed that "agreement" means a binding legal agreement or enforceable obligation to issue the shares. In that case, the employer issued shares for zero consideration pursuant to a performance incentive plan wherein the issuance of shares was entirely based on the employer's qualitative assessment. The corporation

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successfully argued that the section 7 rules did not apply. The arrangement did not constitute an “agreement” since the issuance of shares was entirely at the company’s discretion and was not enforceable by the employee. Thus, the company was able to deduct the cost associated with issuing the shares. The employees were essentially indifferent, as they would be fully taxed on the benefit realized in any event.

2016 CRA comments

In the fall of 2016, the Rulings Directorate of the CRA addressed questions about this decision, confirming its view that, where the issuance of shares is entirely at the discretion of the employer, the usual rules governing employee stock rights might not apply. The CRA stated that “discretionary bonus” plans similar to the *Transalta* plan, in which employers allocate shares based on qualitative performance assessments, will not be subject to section 7. Instead, benefits will likely be fully taxable to the employee with no 50 per cent deduction and fully deductible to the employer. This position provides comfort that simply paying a discretionary bonus with shares instead of cash will not necessarily compromise the corporation’s deduction of the bonus.

The CRA stated that a plan entitling an employee to shares based on measurable performance goals will likely qualify for section 7 treatment. Section 7 will likely also apply where the employee has the choice of receiving shares or cash, but the arrangement constitutes a binding agreement. However, if the employer has the right to choose whether to compensate the employee with shares or cash, it will have no binding commitment to issue shares and section 7 will not apply. This will also be the case for a share appreciation rights plan or a deferred share unit plan, where the corporation is entitled to satisfy commitments with cash or shares at its discretion.

The CRA also addressed stock options with discretionary vesting conditions, where the employer grants employee options subject to allowing employees to exercise only the number specified by the employer in each subsequent year. Such arrangements will not constitute an agreement to issue shares until the time notice is given confirming what may be exercised.

Where shares are instead issued to a trust established by an employer for the benefit of employees, they are generally deemed to be owned by those employees since the time the trust acquired them. The CRA considered a situation in which shares were issued to a trust but no specific employees were allocated shares until later years, and the trustees had full discretion as to which employees received shares or whether any employees received shares at all. Unsurprisingly, the CRA concluded the employees would not be considered to own the shares until they were allocated by the trust. Consequently, employees might not, for example, have held the shares for the two years required to claim the 50 per cent stock option deduction or the capital gains deduction for qualifying small business corporation shares.

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The stock option rules are complex, and the *Transalta* decision, while successful for that particular taxpayer, has made the rules a little tougher to navigate. Careful planning is needed to ensure that employee equity participation plans work as intended. Contact your Collins Barrow advisor for help.

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