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A CLIENT OVERVIEW OF LEGAL TRENDS AND ISSUES

BARRISTERS & SOLICITORS

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In this fast paced, low unemployment, skill hungry, global economy, entrepreneurs and executives are continually searching for ways to attract, retain and motivate employees. Employee stock option plans are becoming a more widely accepted means of attracting and retaining key workers. In this issue of our newsletter, we will discuss employee stock option plans and explain the tax rules for employee stock options.

## Stock Option Plans ~ *Employee Ownership Can Increase Profitability*

### *The Need*

Although traditionally used only for senior corporate executives and management, employee stock option plans ("ESOPs") are becoming an essential compensation component necessary to enhance a business' ability to attract, retain and motivate key personnel and reward significant performance achievements. This is old news to the high-technology industry (especially the dot coms) where broad-based stock options are now almost mandatory in order to attract and retain skilled employees. What is news is the fact that such equity compensation strategies are also becoming popular (read necessary) in other

industries and with non-public, closely held companies.

### *The Benefits*

1. Higher profit growth
2. Increased net profit margins
3. Improved employee productivity
4. Better returns on equity and capital

According to a study conducted by The Toronto Stock Exchange<sup>1</sup>, such were the key differences found in a comparison of public companies with ESOPs versus public companies that did not have ESOPs.

<sup>1</sup> 1996 Canadian Share Ownership Study. The Toronto Stock Exchange

*(continued on back page)*

# Tax Rules for Employee Stock Options



As indicated in another article in this newsletter, equity compensation strategies are becoming increasingly popular in many industry sectors. This article highlights some of the rules in Canada's Income Tax Act ("ITA") governing the tax treatment of one common equity compensation tool, the employee stock option.

## *Granting A Stock Option*

Granting an option to an employee to purchase shares from treasury does not, in and of itself, give rise to any tax issues. The stocks in question can either be shares of the corporation of which the individual is an employee or shares of a corporation that is non-arm's length with the employer corporation.

The application of the stock option rules is not limited to the issuance of shares from treasury. For example, the rules may also apply when a corporation sells shares it owns in the capital of a non-arm's length corporation to an employee. Also, these rules do not require that an option to purchase shares be granted to the employee. Rather, the rules require that there be an "agreement" under which an employee acquires shares.

## *Tax Considerations For The Employee: Income Inclusion*

Subject to proposed changes in this year's Federal Budget (for more information, see below), the

consequences to the employee of exercising the stock option depend on whether the corporation in question is a Canadian-controlled private corporation ("CCPC") as that term is defined in the ITA.

In general terms, a CCPC is a corporation resident in Canada that does not have a class of shares listed on a "prescribed stock exchange" (that is, one of the Canadian and foreign exchanges listed in the regulations to the ITA) and is not controlled by one or more non-residents, public corporations or any combination thereof.

Where an employee exercises an option to purchase shares of a corporation that is not a CCPC, the employee is considered to have received an employment benefit at that time. The benefit is equal to the difference between the option strike price and the fair market value of the shares on the day the shares are acquired, less any amount paid by the employee to acquire the option. This benefit is treated as employment

income and taxed accordingly in the hands of the employee. Thus, in the case of a non-CCPC stock option, the benefit is taxed in the year the option is exercised and the shares acquired.



### *Federal Budget Proposal*

The Federal Budget proposes to defer recognition of the benefit in the case of publicly listed shares until the year in which the shares are disposed of, provided that a number of criteria are met. These criteria include the following:

- The employee must be arm's length with the corporation and cannot own more than 10% of the shares of any class of the employer corporation, the corporation granting the option or the corporation whose shares may be acquired under the option (including, for purposes of this calculation, shares owned by persons non-arm's length with the individual employee in question).
- The shares in question must be common shares (generally speaking) that are listed on a prescribed stock exchange.
- The option strike price cannot be less than the fair market value of the shares in question at the time the option is granted.
- The deferral shall apply only to the first \$100,000 worth of options that vest in the employee each year (based on the fair market value of the shares at the time the option is granted).

Where an employee exercises an option to purchase shares of a CCPC, the benefit (calculated in the same manner as described above) is not taxed immediately. Instead, no income inclusion will occur until the employee "disposes"

of the shares in question, whether by virtue of sale or a "deemed disposition" under the ITA (e.g., immediately prior to death, subject to the "spousal rollover" rules).

In other words, the incidence of taxation is deferred. It is this deferral that was matched to a limited degree for certain public corporation stock options in a proposal in this year's Federal Budget. If the corporation in question ceases to be a CCPC prior to the option being exercised, the administrative position of the CCRA is that the CCPC stock option rules will generally continue to apply.

If an individual receives stock options while an employee but does not exercise them until after his or her employment ends, the above rules will continue to apply.

There are also specific rules in the ITA that may operate to trigger the benefit as described above in the event of an assignment or other transfer of the stock option or upon the individual's death.

### *Tax Considerations For The Employee: Offsetting Deduction*

Where certain criteria are satisfied, the amount of the benefit ultimately taxed in the employee's hands may be reduced by means of a partially offsetting deduction. These criteria are generally as follows:

- If the option strike price was equal to the fair market value of the shares in question *at the time* the stock option was granted and if the shares in question are common shares (generally speaking), then the amount of the benefit ultimately included in income may be reduced by one-quarter. This deduction is applicable to all stock options including CCPC stock options.
- In the case of CCPC stock options only, the amount of the benefit ultimately included in the employee's income may be reduced by one-quarter if the employee held the shares for at least two years prior to disposing of them (this is referred to as the "CCPC Deduction").

The effect of these deductions is to reduce any net inclusion in income from any realized benefit so that it matches the net income inclusion for a capital gain (i.e., on a three-quarter basis).

Both the Federal Budget and the Ontario Budget propose to increase the amount of these deductions in order to match the proposed change in the net capital gains inclusion rate from three-quarters to two-thirds. As the Ontario Budget proposes to reduce the net capital gains inclusion rate from two-thirds to one-half by 2004, it was also proposed that the amount of the offsetting Ontario deductions would be increased in a similar manner. (For more information about the Ontario Budget proposals, see below.)

The CCPC Deduction will not be available until the employee has exercised the option and held the shares for at least two years. Consequently, since the benefit will not be includable in the employee's income until the employee sells the shares, it may be advisable for the employee to exercise CCPC stock options at the earliest possible date permitted pursuant to the terms of the options.

### *Ontario Budget Proposal*

The Ontario Budget also proposes favourable treatment for what is referred to as the "Ontario Research Employees Stock Option Deduction." The Ontario Budget proposes a \$100,000 annual deduction to an individual employee in respect of either an "eligible stock option" benefit or a capital gain resulting from the sale of shares acquired under eligible stock options.

The Ontario Research Employee Stock Option Deduction will apply only to stock options meeting the statutory criteria that are granted after legislation is enacted. There are stringent requirements relating to the employee and the corporation. These requirements include the following:

- The employee must spend at least 30% of his/her time in scientific research and experimental development in Ontario in the year in which the option is granted.
- The corporation must carry on business through a permanent establishment in Ontario and must directly undertake scientific research and experimental development at a permanent establishment in Ontario in the year prior to the year in which the option is granted.
- The corporation must expend certain minimum amounts on qualifying research and experimental development.
- Eligible stock options would be those that qualify for the one of the partially offsetting deductions described above.

### *Going Public And The \$500,000 Capital Gains Deduction*

An individual shareholder who owns shares in a small business corporation ("SBC") that are qualifying small business corporation shares ("QSBC shares") may be able to shelter capital gains realized upon the disposition of such shares against the shareholder's unused capital gains deduction. The ITA rules pertaining to the capital gains deduction apply to shares acquired through the exercise of stock options in the same manner as they apply to shares acquired through other means.

If a SBC goes public, its shares can no longer qualify as QSBC shares and the individual shareholder will not be able to claim the benefit of the capital gains deduction in respect of a subsequent disposition of such shares –

notwithstanding that a portion of the capital gain may have accrued while the shares were QSBC shares.

In order to give an individual shareholder of QSBC shares one last chance to use up the shareholder's capital gains deduction, the ITA contains a special elective provision that permits the shareholder to be deemed to have disposed of his or her shares immediately prior to the corporation going public. The individual shareholder can effectively elect deemed proceeds of disposition (between adjusted cost base and fair market value) and therefore may realize a capital gain that can be offset with the deduction. An employee should therefore consider making this election in respect of shares acquired pursuant to a CCPC stock option, assuming that the shares in question qualified as QSBC Shares. Although making the election referred to above gives rise to a deemed disposition, the provision expressly provides that the deemed disposition does not affect the benefit deferral or the two-year holding period for the CCPC Deduction.

Regardless of whether the election referred to above is made, the CCRA's administrative policy is that, generally the loss of CCPC status does not trigger the recognition of the benefit where an employee acquired shares of a CCPC that subsequently becomes a public corporation. Rather, the general administrative position is that the benefit deferral and CCPC Deduction rules will continue to apply.

### *Tax Considerations For The Employer*

There is no deduction available to the employer corporation upon the grant of a stock option. Thus, although stock options may be used as a component of compensation, unlike salary or bonuses paid to an employee, the employer corporation is not entitled to any deduction in computing its income for tax purposes.

If the stock option would otherwise be immediately exercisable, the employer corporation might wish to consider directly issuing shares to the employee under a share subscription agreement rather than first granting stock options to the employee. In these circumstances, so long as the agreement under which the shares are to be issued is properly drafted, the tax consequences to the employee will be the same as if the employee was granted a stock option and immediately exercised it. However, the process will be simpler for all parties and less costly to the employer corporation.

### *Tax Traps For The Unwary*

The stock option rules contain many tax traps for the unwary. Although it is not possible to consider all of the

potential tax traps in an article of this nature, two traps practitioners often overlook are discussed below.

### *1. Identical properties and adjusted cost base averaging*

The ITA contains specific rules that require “identical properties”, such as shares of the same class owned by the same taxpayer, to have their adjusted cost bases averaged with one another. The ITA also contains a specific rule that requires the amount of benefit included in an employee’s income in any taxation year to be added to the adjusted cost base of shares immediately before the amount is included in the employee’s income.

In any particular situation, the interaction of these rules may be either adverse or advantageous. Accordingly, an employee who has already acquired shares of an employer corporation of a particular class (i.e., through a stock option plan, on the market, etc.) may wish to seek advice prior to exercising stock options to acquire additional shares of the employer corporation.

Where non-CCPC stock options are involved, the interaction of the “identical property rules” will normally result in adverse tax consequences for the employee. This is because stock options are usually exercised only in a rising market (it is the increase in value during a rising market that gives rise to the benefit), and as a result, the adjusted cost base of the pre-existing shares will tend to “water down” the adjusted cost base of the newly acquired stock option shares.

Furthermore, assuming the employee will need to sell shares to finance his or her benefit tax liability, the sale of “identical” shares will be subject to additional capital gains tax to the extent that the proceeds of the disposition in respect of the shares exceed their “watered down” adjusted cost base. With careful advance planning, which may include the use of a trust or transferring pre-existing shares to a spouse, it may be possible to minimize or altogether avoid these tax consequences.

Where CCPC stock option shares are involved, the ITA modifies the “identical property rules” for the purpose of calculating the benefit to deem the employee to dispose of identical shares in the order in which they were acquired. Consequently, if prior to acquiring CCPC stock option shares the employee already owned shares of the same class, the employee will be deemed to sell the originally owned shares first. Thus, the employee may sell such shares without adversely affecting the benefit deferral or the two-year holding period in respect of more recently acquired CCPC stock option shares.

*Addendum:* In *Income Tax Technical News No. 19*, dated June 16, 2000, the CCRA has reviewed its position

regarding the application of the identical property rules to stock option shares. In particular, the CCRA has revised its previous administrative position by accepting that a taxpayer may choose to calculate the adjusted cost base of shares disposed of in a situation “[w]here it would seem obvious” that such shares were originally acquired through the exercise of stock options without taking the identical property rules, as set out above, into account.

A taxpayer who desires to calculate the adjusted cost base of stock option shares in accordance with this new administrative position will be required to specifically identify the shares as having been acquired through the exercise of stock options and demonstrate the “correlation” between their acquisition and disposition. To this end, *Income Tax Technical News No. 19* illustrates the type of situation to which this new method of calculating the adjusted cost base of shares may be applied, by providing an example of a situation where the number of stock option shares acquired equals the number of shares disposed of and the disposition occurs immediately after the exercise of the stock option. However, *Income Tax Technical News No. 19* specifically sets out that this alternative method of calculating the adjusted cost base will not apply if a taxpayer acquires additional shares subsequent to the acquisition of shares through the exercise of stock options but prior to any disposition of shares.

### *2. Rollovers of CCPC stock option shares to holding corporations*

An employee will often wish to transfer personally-held CCPC shares to the employee’s holding corporation to gain more favourable tax treatment of dividends received on the shares or for other reasons. Although the stock option rules permit certain dispositions of CCPC shares to be made without jeopardizing the benefit deferral, an otherwise tax-deferred transfer of personally held shares to the employee’s holding corporation will usually cause the benefit deferral to be lost. Although beyond the scope of this article, in certain situations it may be possible to structure an employee’s affairs in a manner which may avoid this adverse result.

### *Conclusion*

Though employee stock options continue to increase in popularity, there are a number of tax traps for the unwary and tax advice should be obtained. For further information and advice on the above and other tax planning strategies, please contact us.

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## Stock Option Plans *(continued from cover)*

### *What is a Stock Option?*

A stock option granted to an employee gives that employee the right to buy a certain number of shares in the company at a fixed price (the "exercise price") for a certain number of years. Employees who have been granted stock options hope that the share price will appreciate so that they will be able to "cash in" by exercising their options and purchasing their shares at the lower exercise price and then selling their shares at the higher market price.

### *Tax Benefits*

Gains on shares acquired by the exercise of stock options have more favourable tax treatment than regular employment income. While options granted by Canadian controlled private corporations have significant tax advantages, especially if the shares are held for 2 years, certain of such advantages were proposed to be extended to public companies in the recent February 28, 2000 Federal Budget.

### *Is a Closely Held Company too Small to Benefit from an ESOP?*

Owners and managers of non-public companies may question whether their entities are of insufficient size to benefit from an ESOP. Aside from providing a flexible mechanism for companies to motivate employees through share ownership, growth-oriented

smaller businesses can also use stock options to preserve cash while giving employees a portion of the future growth.

### *Does an ESOP Result in a Loss of Control?*

Owners and managers of non-public companies may have concerns that some loss of control may outweigh the clear benefits of implementing an ESOP. Where there are such preservation of control concerns (e.g. a company with one controlling shareholder or a family business), the ESOP can be tailored so that the exercise of stock options is tied to certain triggering events such as the sale of the company or the company going public. In addition, an ESOP can be tailored so that upon the controlling shareholder selling his/her shares (which occurrence can be deemed a triggering event permitting the exercise of stock options), the employee shareholders are also required to sell their shares (obtained by exercising their stock options) to the same party.

More Information – If you have any questions regarding ESOPs or alternative employee incentive plans such as phantom stock option plans and share appreciation rights, please contact us.

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PROFESSIONAL NOTES

Howard Black has been elected Secretary of the Trusts & Estates Section of the Executive of the Canadian Bar Association (Ontario) for the 2000-2001 term.

David Louis wrote a book entitled "Implementing Estate Freezes", published by CCH Canadian Limited as part of the CCH practice library for accountants, to provide easy to understand guidance regarding estate freezes.

Hartley R. Nathan, Q.C. chaired a Canadian Bar Association meeting on "Letters of Intent" February 22nd, 2000. Glyde Hone, one of the speakers, talked on the applicable law.

Daniel Sandler participated in an International Tax Academy Conference on "International Business and Tax Aspects of Investing in Canada" in Amsterdam, The Netherlands April 7th, 2000. Daniel's presentation was entitled "The Canadian Rulings System: Practice and Procedure for the Foreign Investor".

Monty Warsh was the Chair of and spoke at the Osgoode Hall Law School program "Negotiating the Commercial Lease" May 4th and 5th, 2000. In addition, Monty represented the firm at the ICSC Convention in Las Vegas where the firm had a booth in the Canadian pavilion.