TAX ASPECTS OF EQUITY-BASED INCENTIVE PLANS

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A. INTRODUCTION AND SCOPE OF PAPER

This paper is intended to provide an overview of the principal income tax issues in the design and operation of equity-based incentive plans for employees (including officers and directors).

Part B of this paper reviews the provisions of the *Income Tax Act* (Canada)[1] relating to salary deferral arrangements, taxation of employment income and the doctrine of constructive receipt that generally affect the ability to defer tax on employment income, including equity-based compensation.

Part C of the paper contains a description of the main types of equity-based incentive plans, the specific provisions of the Act that are relevant to such plans and the more significant tax issues which often arise in the design and operation of such plans.

Part D of the paper discusses the recently enacted tax withholding requirement applicable to equity based incentives.

Part E of the paper discusses the taxation of certain trust arrangements used to fund or hedge equity based compensation arrangements.

The paper concludes in Part F with a brief discussion of the application of the various tax related rules relating to equity compensation in the income trust context.

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1 R.S.C. 1985, c.1 (5th Supplement) (the "Act").

B. REVIEW OF RELEVANT PROVISIONS UNDER THE *INCOME TAX ACT* (CANADA)[2]

1. Employment Income and Constructive Receipt

The tax objective in structuring equity-based incentive compensation is usually to ensure that amounts will be taxable to the employee only when actually received. Pursuant to subsection 5(1) of the Act, an employee is required to include in his or her income salary or wages received in the year . In addition, any benefits “received or enjoyed” by a taxpayer in a year “in respect of, in the course of, or by virtue of an office or employment”[3] must also be included. However, the term “received” may have a broader meaning than actual physical receipt. The Canada Revenue Agency (“CRA”) has long taken the position that an amount in respect of employment is “received” by an employee or former employee upon the earlier of the date upon which payment is made and the date upon which the employee (or former employee) has “constructively received” the payment.

In this regards, CRA stated in Interpretation Bulletin IT-196R2 that employment income is taxable in the earliest taxation year in which the following occurs:

- the employee receives it;
- absolute enjoyment or use vests in the individual; or

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[2] This section of the paper will focus on the concept of constructive receipt and the rules relating to salary deferral arrangements. The interest accrual rules will not be discussed in any detail. The interest accrual rules are applicable in the context of “debt obligations” and “prescribed debt obligations”. There is a question as to whether a commitment to pay an amount under certain types of incentive arrangements could be construed as a “debt obligation” and, therefore, subject to the interest accrual rules. However, the arrangements discussed in this paper either are inherently not “debt obligations” or are specifically excluded from the operation of the interest accrual rules under subsection 12(11) of the Act.

[3] paragraph 6(1)(a) of the Act.

- it is paid or transferred pursuant to the employee's direction or with his or her concurrence to some other person for the benefit of the employee or such other person.

Before the implementation of the salary deferral arrangement ("SDA") rules, which are discussed below, the doctrine of constructive receipt was frequently the fundamental tax consideration in the design of any deferred compensation arrangement, including equity-based incentive compensation. For example, various contingencies were incorporated into deferred compensation arrangements, both funded and non-funded, to ensure that amounts could not be construed as constructively received on a current basis. Typical contingencies included:

- forfeiture for dismissal without cause or premature resignation;
- forfeiture for violation of non-competition agreements and secrecy clauses; and
- payment of deferred amounts contingent on providing post-retirement consulting services to the former employer.

It appears that early in the 1980's, CRA's position with respect to constructive receipt had reached the point where an employee could successfully elect to defer employment compensation provided he or she did so before becoming entitled compel payment of to the amount being deferred. Consequently, an employee could elect to defer an exact amount of ascertainable compensation provided he or she did so before he or she had a legally enforceable entitlement to that amount. For example, paragraph 11 of Interpretation Bulletin IT-502[4] deals with elections to defer payments under an employee benefit plan ("EBP") and provides as follows:

[4] Dated March 29, 1985, as amended by Special Release dated May 31, 1991.

> Where the terms of an employee benefit plan provide that an employee entitled to benefits thereunder may elect to defer the receipt of a lump-sum amount payment on death, retirement or other termination of employment, it is the Department's view that the amount so deferred would normally be taxed in the year of actual receipt provided the election to defer is made prior to the termination of employment ...

Interpretation Bulletin IT-502 has not been revised with respect to the application of the doctrine of constructive receipt and CRA has issued favourable advance tax rulings for arrangements under which employees are given the opportunity to elect to receive what might otherwise have been bonus or cash incentive payments in the form of phantom or deferred stock units provided the election is made on an irrevocable basis prior to the calendar year to which the cash incentive payment would relate.[5] However, we understand from discussions with the CRA Rulings Directorate that CRA may be focusing more on when the amount is earned rather than when it is payable as a matter of law, and has suggested that constructive receipt could apply if employees make deferral elections after beginning to earn the amount in question.

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[5] See Technical Interpretation 9821425, Financial Industries Division, Income Tax Rulings and Interpretations Directorate, October 19, 1998. Also see Advance Tax Ruling 972099, Financial Industries Division, Income Tax Rulings and Interpretations Directorate, 1997. Also, see Technical Interpretation 5-963509, Financial Industries Division, Income Tax Rulings and Interpretations Directorate, November 21, 1996 dealing with an election of the form of payment of a retiring allowance under a written employment contract and Technical Interpretation 963740, Income Tax Rulings and Interpretations Directorate, December 3, 1996 concerning the application of the doctrine of constructive receipt to surplus in a registered pension plan in which CRA states: *"Constructive receipt is inapplicable because neither the employer nor the employee have a right to the surplus at the time of the wind-up of the RPP and if the election is made to enhance the pension benefits before the right enures to the employer or employee, there can be no income inclusion to any party until actual receipt"*.

2. Salary Deferral Arrangements

(a) History

The rules governing SDA's were introduced in the February 26,1986 Budget in response to certain perceived abuses of the tax system through the use of EBPs and certain unfunded plans, especially by non-taxable employers.

(b) Definition

An SDA is a plan or arrangement, which unlike an EBP and a retirement compensation arrangement ("RCA"), may be funded or unfunded, under which any person has a right in a taxation year to receive an amount after the year.

It must be reasonable to consider that one of the main purposes for the creation or existence of the right is to postpone tax payable by the taxpayer under the Act in respect of an amount that is, or is on account of or in lieu of, salary or wages to the taxpayer for services rendered by him or her in the year or a preceding taxation year. "Salary or wages" is defined for these purposes to include a taxpayer's income from office or employment, but not to include retiring allowances or superannuation or pension benefits.

The definition of an SDA under the Act specifically excludes certain arrangements such as registered pension plans, deferred profit sharing plans and employees profit sharing plans that are subject to their own specific rules under the Act. The definition of an SDA also specifically excludes a plan or arrangement established for the purpose of deferring the salary or wages of a professional athlete for his services as such with a team that participates in a league having regularly schedules games and a plan or arrangement under which an employee has a right to receive a bonus or similar payment that is in respect of services rendered in the year and is to be paid within the ensuing three years (sometimes referred to as the “three year bonus deferral exception”) A specific exclusion from the SDA rules is also available where the arrangement was established primarily for non-resident employees in respect of services rendered outside of Canada.

Furthermore, the definition specifically excludes prescribed plans or arrangements. Regulations 6801(a) and (b) contain rules for plans set up in order to fund leaves of absence which qualify for exemption from the SDA rules. A review of the regulations pertaining to leave of absence plans is beyond the scope of this paper. There is also a prescribed exemption in respect of National Hockey League officials in Regulation 6801(e). Most importantly in the context of equity compensation arrangements, as discussed in more detail below, Regulation 6801(d) excludes from the definition of an SDA certain deferred share unit arrangements where the amount of the benefit is based on the fair market value of the employer’s (or a related corporation’s) capital stock.

As noted above, the SDA definition excludes a plan or arrangement under which a taxpayer has a right to receive a bonus within the next three years in respect of services currently being rendered by him (the “3-Year Bonus Deferral”). This is one of the most useful exceptions to the SDA rules for structuring deferred compensation, including equity-based compensation.

It should be noted that the term “bonus” is not defined in the Act. One issue that sometimes arises is whether a bonus can simply be a deferral of current salary. The authors understand that CRA takes the position that the bonus must be an amount paid in addition to that which would normally be paid to an individual for services rendered.[6] This appears consistent with the "plain meaning" of the terms bonus. However, it may be possible to defer salary that is not yet earned (and the related tax) using certain types of equity-based compensation arrangements. For example, directors' fees and the tax otherwise payable thereon are often deferred pursuant to an arrangement that meets the requirements of Regulation 6801(d). The key in this case is that the directors elect to defer their fees prior to rendering the services to which they relate (thereby avoiding constructive receipt) and the deferral vehicle (i.e., the arrangement under Regulation 6801(d)) is not an SDA.

In order to determine when the SDA rules will apply, it is necessary to work through the components of the definition of an SDA set out in subsection 248(1) of the Act.

(i) "A Right to Receive an Amount"

A right to receive an amount after the year is specifically defined to include a right that is subject to one or more conditions unless there is a substantial risk that one of those conditions will not be satisfied.

The technical notes from the Department of Finance that accompanied the draft SDA legislation recognized that this provision lacked precision and attempted to clarify what in their view was intended by these words:

> As a general rule a substantial risk of forfeiture would arise if the condition imposes a significant limitation or duty which requires a meaningful effort on the part of the employee to fulfill and create a definite and substantial risk that forfeiture may occur.

[6] Technical Interpretation 5-922223, Financial Industries Division, Income Tax Rulings and Interpretations Directorate, September 8, 1992. See also Technical Interpretation 9709717 which states that CRA does not consider amounts received in respect of overtime to be similar to bonuses.

It is intended that the following types of conditions would generally be ignored in determining whether a plan or arrangement is a salary deferral arrangement:

1. *receipt of the deferred amount is contingent on the employee abstaining from competition or making himself available for advice and consultations following retirement or termination,*

2. *receipt of the deferred amount is contingent on the employee refraining from transferring or encumbering his interest in the deferred amount,*

3. *receipt of the deferred amount is contingent on the employee not being dismissed for cause or the commission of a crime, or*

4. *receipt of the deferred amount is contingent on the employee remaining as an employee for a minimum period, say three years, unless there is a definite and substantial risk that the employment may be terminated before the time and in circumstances beyond the control of the employee.*

[emphasis added]

Whether or not the itemized examples are applicable likely will depend on the individual facts and circumstances surrounding the forfeiture conditions under a particular arrangement.

(ii) "In Respect of Services Rendered in the Year or a Previous Year"

CRA has reviewed this requirement in the context of full value plans. For example, CRA has taken the position that in the case of a phantom stock plan that is based on the value of specified shares on a date, the plan is considered to be an SDA, notwithstanding that the value on the payment date may be less than the value at the time that the phantom stock is granted. CRA has stated that in their view where the amount paid to the employee is based on the full value of the specified shares, the phantom shares are usually granted in respect of the employee's past services. (It should be noted that paragraph 8(1)(o) of the Act provides a deduction to the employee in a situation where the value of the shares on the payment date is less than the amounts previously included in income). On the other hand, CRA takes the position that where on a specified date an employee is entitled to receive only the increase in the value of the underlying share, this type of plan (which they refer to as a stock appreciation rights plan - see Part C below) will generally not be considered to be an SDA.[7] CRA bases this position on their observation that where the amount paid to the employee is based on the increase in value of the underlying shares, the appreciation rights are generally granted in respect of the employee's future services.

Regulation 6801(d) provides, with respect to 1986 and subsequent taxation years, that plans or arrangements under which employees receive amounts on retirement or termination of employment based on the fair market value of the shares of their employer's capital stock (or that of a related corporation) do not fall within the ambit of SDA's, subject to certain limitations. This exception from the definition of an SDA is discussed in more detail below.

(iii) "One of the Main Purposes"

The definition of SDA makes it clear that it must be reasonable to consider that one of the main purposes for the creation or the existence of the right is to postpone tax payable under the Act. CRA has stated that it is not its intention that if tax deferral results it may be inferred that one of the main purposes was to postpone tax payable. Nevertheless, where tax deferral has been achieved in a particular arrangement, CRA takes the position that this would be a significant factor to be considered in the evaluation of the main purposes of the plan.

[7] See, for example, Technical Interpretation 5-930745, Financial Industries Division, Income Tax Rulings and Interpretations Directorate, June 1, 1993.

(c) Grandfathering

The SDA rules provide for grandfathering. Where there is an agreement in writing made before February 26, 1986 and the deferred amount is in respect of services rendered before July 1986, the SDA rules will not apply.

If there is an arrangement in writing made before February 26, 1986 and the deferred amount is in respect of services provided after June 1986, then the taxpayer must also be obligated to defer receipt of the deferred amount and must not be able to cancel or otherwise avoid the obligation. Both the deferred amount and income thereon are protected under the “grandfathering” rules.

(d) Tax Consequences

If a plan is an SDA, the “deferred amount” is the amount on which tax is based. The deferred amount under an SDA is any amount that a person has a right under the arrangement, at the end of the taxation year, to receive after the end of the year. If the plan is a trusteed plan, the deferred amount is any amount that a person has a right under the arrangement at the end of the year to receive after the end of the year where the amount has been received, is receivable or may, at any time, become receivable by the trust as, on account or in lieu of salary or wages of the taxpayer for services rendered by the taxpayer in the year or preceding year.[8]

Subsection 6(11) of the Act deems any deferred amount under an SDA to have been received as a benefit in the year by the employee for purposes of paragraph 6(1)(a) of the Act (except to the extent the deferred amount was included in his income for a preceding taxation year) and thus is included in income from an office or employment. Paragraph 6(1)(i), on the other hand,

[8] See definition of “deferred amount” in subsection 248(1) of the Act.

requires amounts actually received by any person in the year from an SDA, to the extent those amounts were not previously taxable to the employee pursuant to subsection 6(11) and paragraph 6(1)(a), to be included in the employee's taxable income.

Paragraph 56(1)(w) provides for the inclusion in income of all amounts received by a person as a benefit (other than an amount received from a trust governed by an SDA) in the year out of or under an SDA in respect of another person except to the extent it was included in income by that other person (i.e., if an SDA provides benefits to a person other than the employee, such as a spouse or designated beneficiary, that other person will be taxable on those benefits to the extent that they have not already been taxed in the hands of the employee as a deferred amount).

The employer may claim a corresponding deduction in its taxation year that contains the end of a calendar year in which the employee includes the deferred amount in his income.[9]

Special rules provide for recapture of an employer's deduction where an employee forfeits his or her right to receive a deferred amount which has previously been included as a benefit in income.[10] Note that "forfeiture: in this context includes the situation in which the ultimate value to which the employee is entitled under the arrangement is less than the sum of the deferred amounts included in the employee's income, which could occur where amounts are based on share values that decline over the deferral period. In this situation, the

[9] Act, paragraph 20(1)(oo).

[10] Act, paragraph 12(1)(n.2).

employee is allowed a deduction for the previously included amount for the year in which he or she forfeits the right to receive the deferred amount.[11]

C. TAX ISSUES RELATING TO THE DESIGN AND OPERATION OF EQUITY-BASED INCENTIVE PLANS

A key consideration for equity-based compensation plans is whether employees will be taxed under section 7 of the Act with respect to their participation in the plan, or whether they will be taxed under section 5 or 6 of the Act. Section 7 applies to arrangements under which employees may acquire shares of their employer or an affiliate and generally taxation is deferred until the shares are acquired. Likely the best known equity incentive taxable under section 7 of the Act is stock options. Other incentives, such as stock appreciation rights, phantom share plans, stock bonuses and restricted stock may also be settled in shares issued from treasury, bringing them within the ambit of section 7. Some of these other incentives may also be settled in cash, in which case section 7 will not apply and there will generally be a heightened concern with respect to the potential application of the SDA provisions of the Act. This part of the paper focuses first on stock options and also reviews certain other equity-based incentives. The paper does not address employee share purchase plans, although they may be subject to section 7 of the Act, on the basis that they tend to be broad-based plans that are more in the nature of savings plans rather than incentive compensation.

[11] Act, paragraph 8(1)(o).

1. Stock Options

(a) Basic Tax Rules

Under an employee stock option, an employer or corporation that does not deal at arm's length with an employer agrees to sell or issue shares of its capital stock or the capital stock of a corporation with which it does not deal at arm's length to the employer's employees or the employees of a corporation with which it does not deal at arm's length, at a fixed price, i.e., the exercise price. The exercise price is normally the fair market value of the share at the time the option is granted. Vesting conditions and other restrictions can be imposed on the exercise of the options and the treatment of shares acquired on exercise . The basic tax rules governing stock options are found in section 7 of the Act. As noted below in connection with income trusts, the "stock option" provisions of the Act also apply to options granted to employees to acquire mutual fund trust units.

No deduction under the Act is permitted to be taken by the employer or any other person in respect of any actual or accounting expense that arises as a consequence of the grant of a stock option or the exercise of the stock option and acquisition by the employee of shares from treasury.

From the perspective of the employee, no income tax is payable at the time of the grant. In the ordinary course, when the employee exercises the stock option, the difference between the price paid by the employee and the fair market value of the share when the option is exercised will be included in the employee's employment income for the year, unless the employee is eligible to defer the amount of the benefit.

Pursuant to paragraph 110(1)(d) of the Act, where an employee acquires shares on the exercise of an option to which section 7 applies, the employee will be able to claim a 50% deduction on the amount of the stock option benefit, provided that the exercise price under the option is not less than the fair market value of the share on the date the option was granted, that the shares meet prescribed requirements under the Regulations[12] and provided the employee deals at arm's length with his or her employer and the parent or affiliate of the employer that granted the stock option (if the employer is not the grantor) immediately after the option agreement is made.

Regarding the requirement under paragraph 110(1)(d) that the shares to which the option relates must be prescribed shares under section 6204 of the Regulations, ordinary common shares will generally qualify as prescribed shares, but shares with redemption or retraction features, special dividend, or liquidation rights will not qualify. In addition, it cannot reasonably be expected that the issuer of the shares (or an affiliate or significant shareholder of the issuer) will redeem, acquire or cancel the shares within two years after they are issued in connection with the exercise of the option. Prescribed share status is assessed at the time the option is exercised, or disposed of.

The redemption, acquisition or cancellation of the shares by any person will not cause the shares to cease to be prescribed shares as long as it was provided for in the option agreement (or a shareholders' agreement or other agreement relating to the shares) and the amount payable does not exceed either (i) the adjusted cost base of the shares to the holder, where the principal purpose of the redemption, acquisition or cancellation provision is to protect the optionholder against a loss in respect of the shares or (ii) the fair market value of the shares immediately before the acquisition, redemption or cancellation, where

[12] See section 6204 of the Regulations regarding "prescribed shares" for purposes of paragraph 110(1(d) of the Act

the principal purpose of the redemption, acquisition or cancellation provision is to provide the optionholder with a market for the shares. In circumstances in which there may be a corporate purpose in acquiring shares from employees there remains a risk that the shares will not be prescribed share because of the principal purpose requirements noted above.

When the shares are ultimately disposed of, any increase in value will generally be taxed as a capital gain as shares acquired under employee stock options are typically held as capital property. The taxable benefit in respect of the stock option included in the employee's income will be added to the adjusted cost base of the shares for purposes of determining the cost base. Subject to an exception which applies if an employee (i) disposes of the shares acquired under the option within 30 days following exercise, (ii) does not acquire or dispose of any other identical shares during the period between exercise and the disposition of the option shares and (iii) makes the necessary election upon filing his or her tax return, the adjusted cost base of the shares is determined based on the average cost of all identical shares held by the employee.

The foregoing rules are modified in certain respects when dealing with Canadian controlled private corporations ("CCPCs"). In particular, there is no income inclusion with respect to CCPC options until the employee disposes of the shares acquired under the options. In addition, the employee may qualify for a 50% deduction of the stock option benefit in respect of CCPC options under paragraph 110(1)(d.1) of the Act provided he or she holds the shares for at least two years before disposing of them. There is no requirement under paragraph 110(1)(d.1) that the shares be prescribed shares or that the exercise price be at least equal to the fair market value of the shares on grant.

(b) Disposition of Options

Options will generally be considered disposed of for purposes of the Act where they are surrendered to a third party, including the grantor. Material changes to the terms of an option can also trigger a disposition. In addition, a "unilateral" termination of an option by the grantor (as sometimes occurs in the context of a corporate transaction where, for example, the underlying shares cease to exist and replacement options are not provided) is deemed under subsection 7(1.7) to be a disposition.

Where an option is disposed of to a person who deals at arm's length with the optionholder, paragraph 7(1)(b) applies. Under this provision, the optionholder must include in his or her income the consideration received upon the disposition of the option. Where the 50% deduction would have applied had the option been exercised it may also apply where the option is disposed of. [13] Therefore, if the optionholder receives the excess of the current fair market value of the shares over the exercise price under the option, in cash, he or she may be able to deduct 50% of that amount in calculating his or her taxable income.

[13] The discussion below regarding the need for an employer election in connection with the exercise of a Tandem SAR in order for the employee to benefit from the 50% deduction is also relevant where cash consideration is paid in connection with a disposition of options that is not pursuant to the exercise of a Tandem SAR.

A disposition (or deemed disposition) of employee stock options does not occur under the Act upon immigration to or emigration from Canada. In addition, a taxable disposition under paragraph 7(1)(b) does not occur where the optionholder contributes options to his or her registered retirement savings plan ("RRSP") or otherwise transfers them to a person with whom the optionholder does not deal at arm's length. Instead, in these circumstances, the optionholder is taxable when he or she, or the non-arm's length transferee, ultimately exercises the option or disposes of it.

It is CRA's position that a disposition will occur when there is a "fundamental change" in the original option. In general, repricing and the addition of cash out rights to outstanding options have been held by CRA (and the courts, in the case of repricing) not to constitute a disposition of the original option. In contrast, replacement of the option shares with different shares is more likely to result in a disposition of the original option.

Deemed "Non-Disposition" of Options

Where a disposition is structured as an exchange of options that meets the requirements of subsection 7(1.4), the original option will be deemed to continue, the optionholder will not be taxable under paragraph 7(1)(b) in connection with the disposition and, if the original options qualified for the 50% deduction, the new options will also generally qualify for that deduction.

In order for subsection 7(1.4) of the Act to apply to a particular exchange of employee stock options, the following conditions must be met:

1. the only consideration that can be received in connection with the exchange by the employee who held the original options are rights to acquire shares under an agreement (i.e. new options) with (i) the corporation that granted the original options; (ii) a corporation that does not deal at arm's length with the grantor of the original options immediately after the exchange, (iii) a corporation formed on the amalgamation or merger of the corporation that granted the original options with one or more other corporations, or (iv) a corporation with which such amalgamated or merged corporation does not deal at arm's length where the rights are in respect of the acquisition of shares in the capital stock of the corporation that is party to the agreement or of a corporation with which it does not deal at arm's length; and

2. the amount, if any, by which the value of the shares covered by the new options immediately after the exchange exceeds the total amount payable by the employee to acquire the shares covered by the new options cannot be greater than the amount, if any, by which the total value of the shares covered by the original options immediately prior to the exchange exceeded the amount payable by the employee to acquire the shares covered by the old options.

Application of Section 7(1.4) - Some Issues

(i) Payment of Cash together with issuance of New Options

Parties to a corporate transaction may wish to provide cash payments or the right to receive cash payments (such as dividend equivalents) at a future date, to employees who had existing options together with new options. If these cash payments relate to the existing options and can be seen as consideration for their exchange for new options, this arrangement will not meet the requirement in paragraph 7(1.4)(b) that the only consideration received by an employee in exchange for his or her existing options is in the form of new rights to acquire shares (i.e. new options) in a qualifying corporation as described above.

(ii) Value of Exchanged Options

In order to remain within subsection 7(1.4), it is essential that the difference between the total fair market value of the shares covered by the new options and the aggregate exercise price of such options immediately after the exchange not be greater than the difference between the total fair market value of the shares covered by the original options and their aggregate exercise price immediately prior to the exchange.

CRA has stated that the determination of fair market value will be a question of fact to be considered on a case by case basis and the Act contains no statutory rules governing the valuation of shares for purposes of section 7, including subsection 7(1.4).

(iii) Relationship of Corporations Participating in Exchange of Options

Under subsection 7(1.4) of the Act, it is a requirement that, where new options are to be issued in connection with an intercorporate transaction such as a merger or reorganization, that the corporation that granted the original options and the corporation that will be granting the new options will be the same corporation (including a corporation formed from the merger of the grantor of the options and one or more other corporations), or corporations that do not deal at arm's length with each other immediately after the exchange of options. In a public spin-off, the new public company may be arm's length from its former parent on the effective date of the spin-off. If optionholders do not exchange their options in the parent for options in the new company before the effective date of the spin-off subsection 7(1.4) may not apply.

(iv) Amendment not Disposition

Subsection 7(1.4) applies only where a transaction occurs that would, in the absence of such subsection, result in the disposition of employee stock options for purposes of the Act. Where an option is amended, subsection 7(1.4) is not relevant. Since repricing of options will generally be considered an amendment, and not a disposition of the affected options, a reduction in the exercise price to a level below fair market value at the date the options were granted will result in the option ceasing to qualify for the 50% deduction. This can be problematic where the share price has dropped dramatically and existing options with an exercise price well in excess of current market values no longer provide any real incentive or reward for performance.

This conundrum was recognized by the Department of Finance, which has proposed amendments to subsection 110(1.7) and the addition of new subsection 110(1.8) that essentially preserve the 50% deduction where options are repriced in a manner that would meet the requirements of subsection 7(1.4) if the repricing resulted in a disposition under the Act. While this should be helpful specifically with respect to repricing, it highlights the fact that subsection 7(1.4) is only available where the change in the options is a disposition – a mere amendment to the terms of an option will not fall within the subsection 7(1.4) and this can result in the loss of the deduction.

(c) Repeal of Tax Deferral Election

Subject to certain limitations on the number and nature of the options involved, prior to the March 4, 2010 Federal Budget, subsection 7(8) of the Act permitted an option holder to defer inclusion in employment income of the stock option benefit relating to publicly traded shares until the year in which the individual sold the underlying shares. This deferral election was repealed with effect from the time of the Budget, with the result that the election is no longer available for any stock option exercised after 4 p.m. on March 4, 2010.

The 2010 Budget provided a form of relief for taxpayers who took advantage of the deferral election in connection with the exercise of their employee stock options subsequently experienced financial difficulties as a result of a decline in the market price of the shares covered under the stock option to the point where the value of the shares dropped below the amount of the deferred tax liability relating to the exercise of the stock option.

As a general rule, CRA took the view that once a stock option was exercised and the shares acquired, a later drop in value was a capital loss that could not be used to off-set the employee's benefit that arose as a consequence of the exercise of the options under section 7. According to the CRA, while this was an unfortunate situation for the employee, the problem resulted from the market risk that the employee took in deciding to keep the shares.[14]

New section 180.01 of the Act provides that if a taxpayer takes advantage of the elective treatment under that section, his or her tax liability on the deferred stock option benefit will not exceed the amount the individual is able to sell the optioned shares for on the open market, taking into account tax relief resulting from the use of capital losses when the optioned shares are sold against capital gains from other sources.

As noted above, where the deferral election is made, the taxpayer is required to include the amount of the stock option benefit in income in the year he/she disposes of the shares acquired through the exercise of the option. Where the taxpayer decides to claim the special elective tax treatment, the

[14] See, for example, CRA Documents 2003-0007795, 2009-0319621M4 and 2009-0331391M4.

taxpayer may elect to pay a special tax for the year equal to the taxpayer's proceeds of disposition (if any) from the sale of the optioned securities.[15] Where such an election is made:

- the taxpayer is able to claim an offsetting deduction equal to the amount of the stock option benefit; and

- an amount equal to the lesser of the stock option benefit and the capital loss on the optioned securities will be included in the taxpayer's income as a taxable capital gain. That gain may be offset by the allowable capital loss on the optioned securities, provided this loss has not otherwise been used.

The special elective treatment is limited to stock options in connection with which the deferral election was made. In addition, individuals who disposed of the shares they acquired through the exercise of their options before 2010 had to make an election for the special treatment on or before their filing due date for the 2010 taxation year (generally April 30, 2011). Individuals who have not disposed of the shares (they acquired through the exercise of options) before 2010 must, in order to take advantage of the special elective tax treatment, do so before 2015. In effect, the last year in which this special elective tax relief will be available will be 2014 during which year the individual must have disposed of his or her remaining shares (which were subject to the original deferral election). The taxpayer will then have until his or her filing due date for the 2014 taxation year to make the election for this special treatment.

[15] The special tax will be equal to two-thirds of such proceeds for residents of Québec.

2. Stock Appreciation Rights ("SARs")

A SAR is a contractual obligation on the part of the employer to pay to the employee an amount (which may be satisfied through cash or the issuance of shares) equal to the increase in the value of the relevant share from the date the SAR is granted until the date the SAR is exercised. in general, SARs will not be treated as SDAs on grant as they have no initial intrinsic value and are considered to relate to services to be provided in the future.

Insofar as deductibility is concerned, the employer will not be entitled to a deduction with respect to the grant or the exercise of the SAR if the SAR is settled by the company through newly issued shares. If the SAR is settled with cash, the employer should be able to claim a deduction on the full amount of the payment in the year the payment is made, assuming the SDA rules are avoided. If the SAR is subject to the SDA rules, while a deduction will be permitted, the timing of the deduction will depend upon the inclusion of the SAR value in the income of the employee.

From the perspective of the employee, there will be no income inclusion at the time of grant provided that the initial value at the date of grant of the SAR, from which the increase will be measured, is no greater than the fair market value of the share at the time of grant. If the terms of the SAR provide that it will be settled in cash (or shares bought on the open market), there is a risk that it could become an SDA and therefore taxable in the year in which it vests and becomes exercisable, even if it is not exercised until a later date. Consequently SARs settled in cash (or shares bought on the open market) are generally designed to be exercised by December 31 of the year in which they vest to avoid creating a "deferred amount" for purposes of the SDA taxing provisions.

If the terms of the SAR provide that it will be settled through the issuance of shares, the SAR should be taxable only when it is exercised, even if it were exercisable prior to that time. At the time of exercise, the employee will be required to include in his or her income for the year, the value of the shares issued to settle the SAR. When the employee disposes of the shares acquired from the settlement of a SAR, any increase in value will normally be taxed as a capital gain.

3. Tandem Stock Appreciation Rights ("Tandem SARs")

(a) Basic Tax Rules

A Tandem SAR is a SAR granted in conjunction with a stock option. Under such an arrangement, when the employee is granted a stock option, the corporation will grant a SAR at the same time. Tandem SARs are also often referred to as "cash-out rights". The Tandem SAR entitles the employee to elect to receive the value of the option, measured by the excess of the FMV of the share at the date of exercise of the SAR over the exercise price stipulated in the option. It will be seen that a Tandem SAR provides an alternative method of providing the value of the stock option to the employee without requiring the employee to purchase shares under the option. The employee may exercise either the option or the related Tandem SAR. If the option is exercised, the Tandem SAR is cancelled and vice versa.

Insofar as deductibility is concerned, the employer will not be entitled to a deduction in connection with the grant or exercise of the Tandem SAR or the related stock option if the Tandem SAR is settled through the issuance of a share.

Historically, if a Tandem SAR was settled by way of a cash payment, the employer was generally able to claim a deduction of the full amount of the payment and the employee could claim the 50% deduction under paragraph 110(1)(d) of the option to which the Tandem SAR related qualified for such deduction. However the March 4, 2010 Federal Budget introduced significant changes to the tax treatment of Tandem SARs, which were enacted on December 7, 2010 with respect to the exercise of a Tandem SAR occurring after 4 p.m. on March 4, 2010. In particular, where Tandem SARs are settled through a cash payment employees are no longer entitled to the paragraph 110(1)(d) deduction unless the grantor of the options to which the Tandem SARs relate elects to forego a deduction in respect of such payment. This measure immediately applies to *all* options exercised (or cash-out rights exercised) after 4:00 p.m. on March 4, 2010, regardless of the date the underlying option was granted.

The grantor's election must apply to all options covered by a particular grant agreement, but not all options granted under a particular option plan, i.e., an election can apply to some but not all employees who hold options granted under a plan and can apply to options granted to a particular employee under one grant agreement but need not apply to options granted to the same employee under a different agreement. The election will apply to the corporation that granted the option and any corporation with which it does not deal at arm's length. It must be filed with the CRA by the grantor corporation and evidence of the election must also be provided to the employee and filed by him or her when filing his or her personal tax return claiming the paragraph 110(1)(d) deduction. The election is made by marking the appropriate box on the employee's T4 for the year in which the election is made.

(b) Cash-Out of Stock Options in the Context of a Corporate Transaction

The Act does not specifically address the issue of whether in a particular circumstance a corporation could be denied a deduction for a cash payment made to compensate employees and other option holders for the surrender of their stock options on the basis that such a payment is on account of capital and therefore precluded by virtue of paragraph 18(1)(b) of the Act.

In the case of a corporate acquisition, it is often commercially and legally expedient to be able to eliminate the previously granted but unexercised stock options of the target corporation. While there are a number of different strategies that might be employed to address the stock options granted by the target corporation in the context of a corporate acquisition, the most efficient mechanism may be to permit employees and other option holders to surrender both their vested and non-vested stock options in exchange for a cash payment equal to the "in-the-money amount" of the stock options (essentially the difference between the fair market value of the target corporation's shares at the time of the surrender less the exercise price payable under the options).

There are three court decisions of note that should be considered where a cash payment is to be made to employees and other option holders in the context of a corporate transaction in exchange for the surrender by those taxpayers of their stock options. The first is the Federal Court of Appeal decision in *The Queen v. Kaiser Petroleum Ltd.* ("*Kaiser*")[16], the second is in the decision of the Tax Court of Canada in *Imperial Tobacco Canada Limited (successor by amalgamation of Shoppers Drug Mart Limited) v. the Queen*[17] ("*Shoppers Drug*

[16] 90 DTC 6603 (FCA), leave to appeal to the Supreme Court of Canada denied June 10, 1991

[17] 2008 DTC 2043

Mart") and the third is the decision of the Tax Court of Canada in *Imperial Tobacco Canada Limited v. the Queen*[18] ("*Imperial Tobacco*").

1. Kaiser Petroleum

In *Kaiser,* the Federal Court of Appeal (the "FCA") held that stock option cancellation payments paid to employees of Ashland Oil ("Ashland" or the "respondent"), which would otherwise have been deductible, were non-deductible capital outlays as they occurred in the context of the acquisition by the respondent's parent of all of the shares of the respondent.

Ashland was a public corporation that had a stock option plan. Kaiser Resources planned a takeover of Ashland. Prior to the takeover, Ashland made an offer to buy out its employees' stock options. As a result, Ashland paid approximately $2.7 million and included that payment as a current and deductible expense for income tax purposes. The FCA held that this payment was not deductible because it was a capital expense. The FCA said:

The respondent, in buying out the 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.

Further, the FCA said,

… the compensation was made by means of a reshaping of the capital structure of the respondent's organization. This feature, in my view, dominates the whole set of circumstances revealed by the evidence and constitutes the guiding element

[18] 2011 DTC 1037

The stock options were initially granted with the objective of compensating its employees. Had Ashland pursued this compensation plan under its original terms, the payments made to its employees would have been deductible. However, Kaiser became concerned that its employees might not continue in their employment following a prospective acquisition of control of Ashland and the stock option plan was amended to allow the option holders to receive stock option cancellation payments as an alternative to exercising their options. The FCA held that one of the respondent's objectives in making the stock option cancellation payments was to compensate its employees, but as the respondent had chosen to do so through a "reshaping of the capital structure" of the respondent, the payments were in the view of the FCA non-deductible capital outlays.

2. Shoppers Drug Mart

In the Shoppers Drug Mart decision , the Tax Court of Canada was able to distinguish Kaiser and concluded that a reimbursement payment made by Shoppers Drug Mart Limited ("SDM") to its parent Imasco Limited ("Imasco") for one-time cash out payments made to SDM employees in the course of a going-private transaction of Imasco was on account of income and properly deductible. In Imperial Tobacco, the Tax Court of Canada ("TCC") considered payments made in connection with the stock option plan of Imasco, the provisions of which included issuing stock options to the officers and key employees of Imasco's subsidiaries. One such subsidiary was SDM. The case involved a going-private transaction in which an arm's length purchaser was to acquire all of the outstanding shares of Imasco. The terms of the transaction included provisions under which Imasco would repurchase for cash any outstanding options to acquire its shares.

At the time of the transaction, employees of SDM held a number of Imasco stock options. Imasco purchased these options directly from the SDM employees for cash, with SDM agreeing to reimburse Imasco for such payments. SDM sought to deduct the reimbursement payments it made to Imasco in computing its business income. The CRA disallowed the deductions.

The issue in this case was whether the payments by SDM were payments on capital account. The CRA did not dispute whether the payments had been made for the purpose of gaining or producing income as required by paragraph 18(1)(a) of the Act, and Bowman C.J. took it to be accepted that the payments were made or incurred for the purpose of gaining or producing income from SDM's business.

Bowman C.J. found that the reimbursements were not expenditures of a capital nature and were therefore deductible in computing SDM's income. In coming to this conclusion, he stated:

I start from the premise that in the ordinary course a payment made by an employer to an employee for the surrender of his or her option under a stock option plan to acquire shares of the company is a deductible expense to the company. This conclusion is not based on any specific provision of [the Act]. It is simply part of employee compensation and is therefore a cost of doing business under section 9.

and further,

Why then does a payment to employees who are option holders become a capital expense just because it is made in the course of a corporate reorganization of the parent company? The short answer is that it does not. The business of SDM continued throughout the reorganization of the Imasco *corporate structure. SDM, as a separate corporate entity, was not being reorganized. It had payrolls to meet and expenses to pay. It may possibly be that the reason for accelerating the vesting of the stock options was to enable as many employees as possible either to exercise their options or surrender them so that BAT could achieve its goal of obtaining all outstanding shares of Imasco. This does not turn the payment of what is patently a revenue expense into a capital expense.*

3. Imperial Tobacco

The *Imperial Tobacco* decision was concerned with the same going private transaction that had led to the cash out of options held by SDM employees. However, in Imperial Tobacco, the options in issue were granted by Imasco, the corporation directly involved in the going private transaction.

In *Imperial Tobacco*, the Tax Court took the view that the decision in *Kaiser* was applicable and denied Imasco a deduction for the cash out payments it made to its employees who disposed of their options in connection with the transaction. In particular, the Tax Court held follows:

It is clear from the Transaction Proposal Agreement at section 5.8 that the mutual intention of BAT and Imasco was that, so far as it was feasible to do so, all outstanding options to purchase shares would be eliminated before the completion of the transaction. If compensation was an element of the decision to make the payments then nevertheless, as in the Kaiser Petroleum case, the reshaping of the appellant's capital structure "dominated[d] the whole set of circumstances ... and constituted[d] the guiding element ..."

4. Deferred Share Units ("DSUs")

DSUs are a form of phantom shares. That is, they represent a contingent right on the part of an employee to receive shares of the employer or a corporation related to the employer (or the value of shares in cash). DSUs are generally understood to refer to arrangements which meet the requirements in Income Tax Regulation 6801(d), which, as noted above, provides a specific prescribed exception to the SDA rules.

DSUs may be fully vested when issued or issued subject to vesting conditions. During the period between grant and payout additional DSUs are frequently credited to participants in a DSU plan based on dividends paid on the underlying shares. One of the more common uses of DSUs is to provide equity compensation to corporate directors (who are considered "employees" for purposes of the Act).[19]

In general, in order to meet the requirements of Regulation 6801(d) and avoid taxation before the date of payment: (i) there must be an arrangement in writing between the employer or related corporation and the employee under which payments may be made to the employee or, after his death, a dependent or relation or the employee, or his or her legal representative; (ii) the DSU must be payable no earlier than the date of the employee's retirement, termination of employment or death, or in the case of a director, resignation, retirement from the board or death, (iii) payment must be no later than the end of the calendar year following the year in which the employee terminates employment, retires or dies, or in the case of a director the end of the calendar year following the year in which the individual ceases to be a director <u>and</u> is not otherwise employed by the

[19] Payments cannot be made unless the individual has no employment relationship with, and is not a director of, the corporation or of any affiliate of the corporation.

company or dies; and (iii) the value of the DSU must be based on the fair market value of the share of the employer or a corporation related to the employer determined at any time within the period that commences up to one year before the date of payment and ending on the date of payment.

DSUs may be settled in cash, shares bought on the market or, less commonly, through the issuance of shares.[20] During the vesting period, employees may receive additional DSUs or cash based on dividends declared on the shares of the company.

Insofar as deductibility is concerned, the employer will not be entitled to a deduction for the value of the benefit in respect of the grant or settlement of the DSU if the DSU is settled through the issuance of a share. If the DSU is settled in cash (including cash required to be used to purchase shares on the market), which is the most common method of settlement, the employer will be entitled to deduct the entire amount of the payment made in respect of the settlement in the year the payment is made.

The employee will not be taxable until the year in which payment is received in respect of the DSU if the DSU is structured to meet the requirements of Regulation 6801(d). This is the case whether the DSU is settled in cash or shares. The amount of the payment will be included as employment income and subject to full taxation at the employee's marginal tax rate.

DSUs are generally unfunded to avoid the application of the retirement compensation provisions of the Act.

[20] Where a plan mandates that units will be settled through the issuance of shares the plan, technically, will be subject to tax pursuant to section 7 of the Act, not the SDA rules and Regulation 6801(d). This section of the paper focuses on plans designed specifically to comply with Regulation 6801(d).

While DSUs have traditionally been used to allow directors to defer fees, some corporations have established DSU plans for executives, perhaps in response to increased regulatory pressure to defer larger portions of executive compensation and/or as a means of assisting executives to more quickly satisfy their share ownership guideline obligations (DSUs are typically treated as shares under such guidelines).

5. Restricted Stock Units (RSUs) and Stock Bonuses

RSUs, like DSUs, are a form of phantom shares. RSUs can be granted based on a formula determined by the employer (which should be set out in an RSU plan document or agreement with the employee). Typically, RSUs are granted with vesting conditions (e.g., based on service and/or the attainment of corporate/personal performance objectives). During the vesting period, employees may receive additional RSUs or cash based on dividends declared on the shares of the company. Upon the satisfaction of vesting conditions, the employee is eligible to exchange RSUs for shares of the employer or for the equivalent value in cash.

Stock bonuses are, in essence, bonuses payable in the form of shares of the employer or non-arm's length corporation. If the stock bonus is in the form of shares issued from treasury CRA's position is that it is subject to section 7 of the Act, and the stock bonus is taxed in substantially the same way as RSUs settled in shares issued from treasury.

Insofar as deductibility is concerned, the employer will not be entitled to a deduction in respect of the expense associated with the grant or settlement of the RSUs if they are settled by the employer through newly issued shares. If RSUs are settled in cash, the employer will be entitled to a deduction for the amount of the RSU cash payment in the year the payment is made, subject to the general restriction under the Act that any deduction must be reasonable in the circumstances.

If the terms of the RSUs provide that they will be settled through the issuance of shares, the employee will be taxable in the year in which the shares are acquired by the employee under the RSUs and the taxable benefit in such case will be the fair market value of the share at the time of its issuance. RSUs that are required to be settled in shares issued by the employer or an affiliate from treasury are taxed pursuant to section 7 of the Act. One of the important implications of this for the design of an RSU plan is that paragraph 7(3)(a) of the Act provides that where there is an arrangement that falls within section 7 an employee is deemed not to have received or enjoyed any benefit under or because of the arrangement except as provided by section 7. In effect, this excludes the application of the SDA rules to arrangements governed by section 7 of the Act. In practice this means that RSUs settled in shares issued from treasury can provide for vesting/deferral that extends past three years without creating an SDA.

RSUs and stock bonus plans settled through the issuance of shares do not qualify for the 50% deduction under paragraph 110(1)(d) because the employee does not pay any amount for the shares. However, if the corporation is a CCPC an employee may still qualify for the 50% deduction under paragraph 110(1)(d.1) provided the employee holds the shares for at least two years.

If the terms governing an RSU provide that it will be settled with cash, or cash or shares at the grantor's option, in order to avoid an immediate income inclusion, it will be necessary to consider the application of the SDA rules. Generally, characterization an SDA can be avoided if cash payments are made on or before the end of the third year following the year in which the RSU is granted. Performance criteria attached to the RSUs may also be sufficiently stringent that there is a substantial risk that the RSUs will not vest. In such a case the RSU arrangement will not be an SDA (see below re: Performance Share Units). If the application of the SDA rules is avoided, the employee will not be subject to taxation until the employee receives payment. If the SDA rules are applicable to an RSU, the RSU could be taxable to the employee in the year the RSU is granted and in subsequent years, until payment, if the RSU value increases from year to year.

RSUs may be funded or unfunded. If funded, the funding vehicle will typically be an employee benefit plan ("EBP") trust for purposes of the Act. An overview of EBPs is set out in Part E below.

6. Performance Share Units ("PSUs")

"PSU" usually refers to an RSU that is subject to performance-based vesting. Accordingly, the income tax issues for the employer and the employee are essentially the same as those which exist for "regular" RSUs. As with "regular" RSUs, the principal tax issue is avoiding the application of the SDA rules.

7. Restricted Stock

Under a restricted stock arrangement, shares are issued to the employee from treasury, subject to restrictions on the sale of the shares for a period of time (other restrictions regarding voting, dividends, etc., may also be imposed). The shares are normally subject to forfeiture if conditions such as continued employment for a specified period of time are not met. Shares may be issued directly to the employee or held in trust until the restrictions expire. Restricted stock plans are not as common in Canada as other types of incentive arrangements due to the generally unfavourable tax treatment, as discussed below.

From the perspective of the employer, the income tax treatment is similar to that described above in respect of stock options (i.e., no deduction will be permitted in respect of any expense associated with the grant or vesting of the restricted stock award or in respect of the employee's income inclusion).

The employee will be required to include in income the "fair market value" of the restricted share at the time it is granted to the employee (i.e., when the employee acquires the indicia of ownership – right to vote, right to dividends, etc.). In determining the fair market value for the share, CRA has indicated that it will accept a discount from the market price to reflect the effect of the risk of forfeiture and resale restrictions during the vesting period, although this is not specifically addressed in the Act. If the employee forfeits the share, the employee will usually not be entitled to a deduction from his or her employment income in recognition of the previous inclusion. One exception arises where the restricted shares are issued to a trust and upon forfeiture the trust disposes of the shares back to the issuer for an amount not in excess of the amount paid by the employee to acquire the interest in the restricted shares (usually zero). In that case, the employee will be eligible for a deduction from employment income under subsection 8(12) of the Act in respect of the forfeiture. The employee may be entitled to a capital loss which could be used to offset other capital gains, but not used to offset employment income.

When the employee disposes of the share, any increase in value will be taxed as a capital gain.

D. TAX WITHHOLDING IN RESPECT OF EQUITY COMPENSATION

The 2010 Federal Budget also introduced changes to the rules relating to an employer's obligation to withhold and remit tax in connection with the exercise of stock options after 2010. These to the withholding requirements also apply to other share compensation arrangements including, for example, restricted stock awards, restricted share units (RSUs), deferred share units (DSUs) and performance share units (PSUs) which are settled through the issuance of shares from treasury. In particular, section 153 of the Act, which provided for tax withholding from various amounts, was amended with effect from January 1, 2011, to add new subsections 153(1.01) and 153(1.31). Subsection 153(1.01) requires an employer to make withholdings from the employee's remuneration determined on the hypothetical basis that the deemed employment benefit that arises as a consequence of the exercise of the options (or, in the case of RSUs, for example, the acquisition of the shares by the employee) is paid as a cash bonus. New subsection 153(1.31), stipulates that the Minister of National Revenue will not be entitled to consider the fact that the benefit arose from the acquisition of shares as the basis for a discretionary reduction in withholdings.

Neither the 2010 Budget proposals nor the actual amendments to the Act address what should happen if the amount of the individual's cash remuneration is not sufficient to fund the withholding obligation. It may, therefore, be necessary to provide contractually for various means of funding the tax withholding obligation in the instrument providing for the grant of equity award, such as the sale of shares or a payment by the employee to the employer.

The changes to the withholding requirements do not apply to options and other share-based awards (where shares are issued from treasury) granted before 2011 provided the options (or other equity awards) were granted pursuant to a written agreement that (i) was entered into before 4 p.m. on March 4, 2010, and (ii) includes a written condition prohibiting disposition of shares acquired under the award.

E. USE OF TRUSTS IN CONNECTION WITH EQUITY INCENTIVE PLANS

An EBP trust (a “EBP trust”) is sometimes used in conjunction with a RSU or PSU plan to acquire employer or parent company shares on the open market. The shares would be used to settle awards under the plan that become vested. In effect, the shares held in trust provided a hedge for the corporation that granted the RSUs and usually security for the participating employees.

In general, an EBP is defined under the Act to mean an arrangement under which an employer, or any person with whom the employer does not deal at arm's length, makes contributions to another person and under which one or more payments are to be made to or for the benefit of employees or former employees of the employer or to persons who do not deal at arm's length with any such employees or former employees.[21] Assuming that the employer (or an affiliate of the employer) makes contributions to the EBP trust and the fact that the employer may use EBP trust assets to satisfy payment of awards under a phantom share plan means that the EBP rules under the Act are applicable, unless the arrangement constitutes an SDA or retirement compensation arrangement (“RCA”).

RCAs involve funded arrangements to provide benefits after an employee’s retirement or other cessation of employment. In general, phantom share plans are structured to pay out while a participant is employed and

[21] Act, ss.248(1), definition of EBP.

cessation of employment is not a requirement to receive a benefit under a phantom share plan. Consequently, a typical phantom share plan will not be an RCA. As discussed above, an SDA can arise whenever the payment of an amount in respect of salary or wages for services rendered in a current or prior tax year is deferred to a subsequent year. Phantom share plans generally are structured to take advantage of what is sometimes referred to as the “three year bonus exception” to the SDA definition. Under the three year bonus exception, as discussed above, provided the phantom shares are settled by December 31 of the third year following the year in which the employee provided the services to which the grant relates, the phantom shares should not result in an SDA.

Tax Treatment of Canadian participants[22]

Where shares are distributed from the EBP trust to a Canadian participant the fair market value of the Shares at the time of distribution will constitute income from office or employment and must be included in income by the Canadian participant in the year of receipt.[23]

In this situation, the Canadian participant is deemed to have acquired the Shares at a cost equal to the greater of their fair market value or the adjusted cost base of the Canadian participant’s interest in the EBP trust immediately prior to the distribution of the Shares.[24] Since the Canadian participant is also deemed to have disposed of his or her interest in the EBP trust for proceeds of

[22] In this paper “Canadian participant” refers to an employee of the employer or an affiliate of the employer who is a resident of, and regularly employed in, Canada.

[23] paragraph 6(1)(g) of the Act

[24] subparagraph 107.1(b)(ii) of the Act

disposition equal to the adjusted cost base of the interest (if any) immediately before that time, no gain or loss is recognized on its disposition.[25]

Tax Treatment of the EBP trust

Under a typical structure involving a phantom share plan and EBP trust, the plan would provide for the employer to fund awards of phantom shares payable to Canadian participants by making contributions to the EBP trust. Contributions to the EBP trust by the employer would be used by the EBP trustee to purchase shares on the open market. The EBP trust would earn dividend income on its holdings of shares and may also earn capital gains on any disposition of shares. All income earned by the EBP trust would be taxable at the highest marginal tax rate.[26] As an *inter vivos* EBP trust, the taxation year of the EBP trust coincides with the calendar year.

An EBP trust may deduct from its income for the year amounts paid to a beneficiary of the EBP trust.[27] As a result, where a EBP trust distributes all its income, after expenses for the year to beneficiaries of the EBP trust, it will have no income for the year and therefore no tax owing.

Dividend Income and Capital Gains

Income earned by an ordinary *inter vivos* trust may retain its character when it is paid to a beneficiary, provided that the trustee makes the appropriate designation.[28] For example, where a trust earns dividend income or capital gains, a portion of such income may be designated as forming a part of the

[25] paragraph 107.1(c) of the Act

[26] subsection 122(1) of the Act

[27] paragraph 104(6)(a.1) of the Act

[28] See, for example, subsections 104(19) and 104(21) of the Act

income paid to the beneficiary. This enables the beneficiary to benefit from the special tax treatment afforded to dividend income and capital gains. However, with respect to a EBP trust governed by an EBP, subsections 104(19) and 104(21) of the Act, which apply to designations of dividends and capital gains, respectively, are being amended with effect from July 2005 to eliminate the ability to make such designations with respect to an EBP trust. Moreover, even for periods prior to the effective date of these amendments it was unclear whether such designations would provide any advantage.

Technically a EBP trust is subject to alternative minimum tax ("AMT") under sections 127.5 to 127.55 of the Act. Although an EBP trust is not exempt from the AMT rules, the EBP trust should not be subject to AMT provided it pays each year to its beneficiaries all dividends it receives and capital gains it realizes in the year (and any other income [if any] earned by the EBP trust in the year). This is because the EBP trust's "adjusted taxable income" under subsection 127.52(1) of the Act, which is the base upon which AMT is calculated, would be nil (as would be the EBP trust's Part I tax).

Tax Treatment of Employer - Contributions

Contributions made by the employer to the EBP trust will generally not be deductible when made.[29] The rules relating to EBPs are intended to ensure that

[29] Paragaph 18(1)(o) of the Act. However, contributions made to an EBP in respect of an employee who is not resident in Canada and is regularly employed in a country other than Canada, and cannot reasonably be regarded as having been made during a period when the employee is resident in Canada, will be generally deductible when made (see paragraph 18(10)(a)). As a technical matter, if employer were to rely on paragraph 18(10)(a) to support an immediate deduction relating to a non-resident employer employee, the general provisions of the Act relating to deductions (including paragraph 18(1)(b)) are applicable. Consequently, if a contribution to the EBP trust (which employer may decide to make in order to fund an award) were characterized by CRA as a capital outlay rather than a business expense, there is a limited risk that such contribution would never be deductible to employer. This is not the case with respect to Canadian participants who are residents of Canada since in that situation the specific deduction mechanism in section 32.1 would be applicable.

the employer's deduction is conditional upon contributions to the EBP trust being included in the income of employees. Under an EBP, the employer's deduction for a taxation year in respect of an EBP is the amount allocated to the employer by the EBP trustee to the extent that it does not exceed the total of the employer's contributions for the year or a preceding year to the plan that were neither previously claimed as a deduction or refunded to the employer.[30] The allocation made by the EBP trustee to the employer is the amount by which the total of all payments out of the plan during the year to employees or former employees of the employer, excluding a return of employee contributions, exceeds the income of the EBP trust for the year.[31]

Paragraph 32.1(1)(b) of the Act provides a final deduction to the employer once the plan's obligations to the members are satisfied and none of the plan assets will thereafter be available to the employer. This final deduction is limited to the portion of the amounts previously contributed to the plan that have not been previously deducted or refunded to the employer.

Tax Treatment of Employer – Income Inclusions

Amounts received by the employer out of the EBP trust will be included in computing the income for the year of the employer under one of two possible inclusions under the Act. First, income earned by the EBP trust and paid to the employer will be included in computing the income for year of the employer under paragraph 12(1)(m) (or possibly paragraph 12(1)(j)) of the Act. As was noted above, such amounts paid to the employer will be deductible in computing the income for the year of the EBP trust. As a result, it will be the employer rather

[30] Paragraph 32.1(1)(a) of the Act

[31] Subsection32.1(2) of the Act

than the EBP trust that will pay income tax on income that is earned by the EBP trust and paid out to the employer.

Secondly, under paragraph 12(1)(n.1) of the Act, the employer will be required to include in its income for the year *all other amounts* received in the year out of the EBP trust, to the extent that such amounts exceed the excess of amounts received to date by the employer over the undeducted portion of the employer's contributions made to date. As a result, amounts included in computing the employer's income for the year under 12(1)(m) will not also be included under 12(1)(1)(n.1) of the Act. As an example, returns of employer contributions would be captured under 12(1)(n.1) rather than 12(1)(m).

The employer will need to give further consideration as to how it will handle dividend income earned by the EBP trust. CRA has stated that where the terms of an EBP provide for <u>both</u> the payment of dividend income earned by the EBP trust to the employer and the contribution by the employer of an equivalent amount in the same or a subsequent year, CRA will not permit the EBP trust to deduct in the calculation of its taxable income such amount distributed to the employer. [32]

Tax Treatment of Distribution of Shares from the EBP trust

Where a EBP trust distributes property to a beneficiary, the EBP trust is deemed to have disposed of the property for proceeds of disposition equal to the cost amount of the property to the EBP trust immediately before that time.[33] As a result, if the EBP trust were to distribute Shares to a Canadian participant, the

[32] See CRA Technical Interpretation 9526615, November 29, 1995. The issue was also raised more recently, in passing, in Advance Tax Ruling 2000-0010723.

[33] Subparagraph 107.1(b)(i) of the Act

EBP trust would not realize any capital gains or losses as a result of the distribution. In contrast, if the EBP trust were to sell Shares at a gain and not distribute the gain to the employer or the Canadian participants, the EBP trust would be subject to tax.

It is CRA's position that tax should be withheld in respect of distributions from an EBP trust. Where distributions are in shares, the following two approaches appear to be the most common methods of implementing tax withholdings:[34]:

- provide for awards to be settled partially in shares from the EBP trust and partially in cash from the employer – this would mean the portion of the award payable in cash would not be hedged by the EBP trust

provide for the EBP trust to sell a portion of the shares immediately prior to the distribution date and distribute cash and shares, with the cash being remitted directly to CRA on account of withholdings – this should permit a more complete hedge of the liability associated with the awards and to the extent that the sale of shares results in a capital gain to the EBP trust, the proceeds are fully distributed so the EBP trust should be able to claim a deduction in calculating its income for the year of distribution

F. APPLICABILITY IN THE INCOME TRUST CONTEXT

In general, the equity-based compensation arrangements described above will apply to income trusts. The one significant exception is Regulation 6801(d), which applies only to corporations and their employees/directors.

[34] These are two common approaches in the author's experience. Often methods of satisfying tax withholding obligations may also be available.

Regarding section 7 of the Act, until 1998, it applied only to agreements to issue shares of a corporation. Effective in 1998, section 7 was amended to apply to units of a mutual fund trust. In the case of an income trust, so long as the particular income trust fits within section 7, options and RSUs that provide for the issuance of units of that trust should qualify for taxation under section 7. The key issues will be:

(a) is the income trust a mutual fund trust for purposes of the Act – most will be; and

(b) are the employees who will be receiving the trust units employees of the income trust or a corporation that does not deal at arm's length with the income trust.[35]

Assuming an option or RSU arrangement established by an income trust meets the key requirements of section 7, a related question centers on how to allow participants to share in the distributions they would otherwise have received, given that much of the value in the income trust context is associated with the distributions. One approach is to reduce the exercise price. While this may result in the loss of the 50% deduction it will provide and some measure of deferral, and the absence of the 50% deduction may not be a problem if the unit price has not increased to any significant degree. An RSU-type arrangement where the relevant phantom trust units reflect distributions is also possible.

Equity based plans for employees of income trusts that provide for cash payments can also be viable, but as with such plans for employees of

[35] In this regard, note subsection 7(1.11) of the Act which provides that for purposes of section 7, a mutual fund trust is deemed not to deal at arm's length with a corporation only if the trust controls the corporation.

corporations, care must be taken to avoid the application of the SDA provisions of the Act.