NEW STOCK OPTION RULES

1. INTRODUCTION

This paper concerns the new rules relating to stock options. It discusses the various provisions of the new rules and looks at some of the planning opportunities that exist with these new rules. Finally, it considers whether stock options are the best way to remunerate employees.

The stock option rules deal with agreements under which employees of a corporation or mutual fund trust acquire rights to purchase securities of the employer (or a person with whom the employer does not deal at arm's length). There are two main issues with the stock options benefit:

a) The timing of the stock option benefit; and

b) The amount of the benefit after deductions.

Most of the new rules address the timing of the stock option benefit and not the calculation. The calculation continues to be a stock option benefit in income and a deduction for 50% of the income inclusion if certain conditions are met.

In the past, the main issue in the timing of the stock option benefit was whether the subject company was a Canadian-controlled private corporation ("CCPC"). The old legislation provided that when an option of a non-CCPC was exercised, there was an employment income inclusion in the year of exercise calculated as the difference between the fair market value of the share at the time of exercise and the cost to purchase the option. If an employee were to exercise the stock options of a CCPC, then there was no income inclusion until the shares were disposed of.[1] As a response to criticism that there was inequity between the Canadian and U.S. rules, the government tabled legislation that deferred the income inclusion of a stock option benefit of a public company until the security is disposed as opposed to being exercised. The Canadian rules are now much closer to those of the U.S.

[1] Subsection 7(1.1)

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	Old Rules		New Rules	
	CCPC	Public Co	CCPC	Public Co
Income inclusion at grant of option	No	No	No	No
Income inclusion at time of exercise (if conditions met)	No	Yes	No	No
Deduction from income (if conditions met)	Yes	Yes	Yes	Yes

2. General Conditions for Deferral

The new legislation provides for the deferral of the stock option benefit for non-CCPC's. The general income inclusion rule in subsection 7(1) states that it is subject to subsection 7(1.1) and the new subsection 7(8). Subsection 7(8) provides for the deferral of the stock option benefit for non-CCPC's until such time as the shares are disposed of. This deferral is available if:

a) the acquisition is a qualifying acquisition; and

b) the taxpayer elects, in accordance with subsection 7(10), to have this subsection apply in respect of the acquisition.

In order to be a qualifying acquisition, four conditions must be met. In order to file a valid election, three conditions must be met. Therefore, there are seven conditions in total that must be met before a taxpayer is able to take advantage of the new deferral rules. Each of the main conditions shown above will now be discussed in more detail.

a) Qualifying Acquisition – 7(9)

The first condition for deferral is that the acquisition must be a qualifying acquisition. Subsection 7(9) states that the acquisition of a security through a stock option is a qualifying acquisition if it meets the following four conditions:

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i) The first condition is that the acquisition of the security occurs after February 27, 2000;

ii) The second condition is that the taxpayer would normally be able to deduct an amount under paragraph 110(1)(d);

iii) The third condition is, if the stock option is for shares in a corporation, the taxpayer was not, at the time immediately after the agreement was made, a specified shareholder.

iv) The fourth condition has to do with the shares being listed on a prescribed stock exchange.

Each of the above conditions will be examined in more detail below.

i) **<u>Acquisition Date</u>**

Pursuant to paragraph 7(9)(a), the stock option exercise must occur after February 27, 2000. This date has nothing to do with when the stock options were granted or when they were vested. When the stock option vests will have ramifications in terms of the specified values as defined in subsection 7(11). However, it is not crucial in the definition of a qualifying acquisition.

<u>ii) **Deduction Per Paragraph 110(1)(d)**</u>

Generally a taxpayer is able to deduct an amount pursuant to paragraph 110(1)(d) if:

(1) the amount paid by the employee to acquire the security was not less than the fair market value of the security when the option was granted;

(2) the employee was dealing at arm's length, immediately after the option was granted, with the employer, the entity that granted the option, and the entity under which the securities could be acquired under the option; and

(3) if the security is a share, it is an ordinary common share.[2]

iii) **Specified Shareholder**

A specified shareholder is defined[3] as a person that owns, directly or indirectly, at least 10% of the issued shares of any class of the capital stock of a corporation or a related corporation.

In this case, the taxpayer cannot be a specified shareholder of:

(1) the company that issued the stock option;

(2) any corporation that, at that time, was an employer of the taxpayer and was not dealing at arm's length with the issuing corporation;

(3) the corporation of which the taxpayer had a right to acquire a security; and

(4) if there were exchanges of options to which subsection 7(1.4) applied, the specified shareholder test applies to the original option.

iv) **Listed on Prescribed Stock Exchange**

There are two conditions for this test to be met:

(1) at the time of the acquisition, the shares are listed on a prescribed stock exchange;[4]

(2) where the stock option was acquired by the taxpayer as a result of one or more dispositions to which subsection 7(1.4) applied, none of the stock option benefits acquired was for shares of a company that was not listed on a prescribed stock exchange.

[2] Regulation 6204.
[3] Section 248.
[4] See regulation 3200 or 3201.

The rules in paragraph 7(9)(d) are there in order to ensure that the $100,000 vesting limit discussed in new paragraph 7(10)(c) cannot be avoided by establishing a class of shares exclusively for employee options, which have little or no fair market value at the time the options are granted but which would have the potential for growth, similar to other shares of the corporation. In other words, these rules only apply to those shares that, when acquired, would be traded on a prescribed stock exchange.

All of the four tests discussed above must be met in order for a taxpayer to be able to consider deferring the stock option benefit.

b) Election for Purposes of the Deferral - 7(10)

As stated above, in paragraph 7(8)(b), a taxpayer must elect, in order to have the deferral apply. In order for an election to defer recognition of the employment benefit from a stock option, the following three conditions must be met:

i) The first condition is that the election is filed in prescribed form and manner before January 16 of the year following the year in which the stock option is exercised to a person who would usually be required to report the employment income from the stock option.

ii) The second condition is that the taxpayer is resident in Canada at the time of acquisition.

iii) The third condition is that the specified value of shares that vest in the year cannot exceed $100,000.

Each of the above conditions will be examined in greater detail.

i) **Prescribed Election**

The taxpayer is required to notify one of the entities listed below by January 16th that the taxpayer wishes to make the deferral. Under regulation 200(5), each of the following will then be jointly liable for reporting the deferred employment benefit to the government:

(1) the employer;

(2) the entity that granted the option; and

(3) the entity whose security is acquired under the option.

This allows all of the above entities to determine who should be responsible for reporting the deferral employment benefit. Each of the parties is considered to have satisfied the filing requirement if one of the parties satisfies the requirement.

The prescribed form for the above entities will be the employee's T4 slip for the year in which the security is acquired and the deferred amount will be reported as a separate item on that slip. Pursuant to subsection 7(16), the taxpayer is also required to file a Form T1212 each year that a deferral security is held. This form reflects the stock option benefit deferred. This form must be filed even if there was not a disposition in the year.

ii) **Resident in Canada**

Those taxpayers who leave the country and then exercise an option will not be able to file this election. Therefore, if a taxpayer is leaving the country, the taxpayer should consider exercising an option where the deferral is available so that paragraph 7(10)(b) will not apply so as to deny the ability to defer the income inclusion.

iii) **Specified Value – 7(11)**

As stated in 7(10)(c) above, one of the crucial calculations or amounts is the specified value of the security. The specified value is generally defined as the fair market value of the security at the time the option was granted. This is not the exercise price.

If, however, the number or type of securities that are the subject of the stock option have been modified in any way after the time that the original stock option was granted, then the fair market value of the share discussed above is adjusted to account for the modifications. In other words, it is the formula: A ÷ B.

- ***A*** is the fair market value of a security that could be acquired at the time that the stock option is granted.
- ***B*** would normally be 1. Otherwise, it is adjusted for stock splits and consolidation.

Shown below are two examples of how the specified value is calculated and how the election can be used to minimize taxes.

Example 1

The first example shows how the specified value is calculated and how to choose which options upon which an election should be made.

Facts

1. January 1, 2001 - 10,000 options granted; fair market value and exercise price \$5 – vest January 2003
2. January 1, 2002 - 10,000 options granted; fair market value and exercise price \$20 – vest November, 2003
3. All options are exercised in December 2003.
4. Fair market value of shares on December 2003 is \$150.

Analysis

The specified value of shares acquired from options granted in January 1, 2001 would be \$50,000 (10,000 x \$5). The specified value of the shares acquired from options granted in January 2002 would be \$200,000 (\$20 x 10,000). The total specified value of options that vest in 2003 is \$250,000, which is in excess of the \$100,000 limit. Therefore, the full stock option benefit cannot be deferred. In this case, one should elect to defer the largest stock option benefit. Since the larger stock option benefit is on those shares that were granted in January 2001 - \$145 (\$150 - \$5), an election should be made to defer the full amount of this benefit.

One can still defer a portion of those stock options that were granted in January 2002. Since the specified value of the shares granted on January 1, 2001 is $50,000, then an additional $50,000 of specified value from the January 2002 options can be deferred. In this case, 2,500 of the options granted in January 2002 can have the stock option benefit deferred ($2,500 x $20 = $50,000). The stock option benefit for the other 7,500-share option granted in 2002 would have to be included in income in the year of exercise.

Example 2

This second example reflects the calculation when there are stock splits or corporate combinations.

Facts

1. Company X grants option with fair market value and exercise price of $10 to acquire ten shares.
2. Company Y acquires Company X at a time when Company X's shares are worth $100, and Company Y's shares are worth $200.
3. Options of Company X are exchanged for options to acquire five Company Y shares at an exercise price of $20.
4. The Company Y options are exercised.

Analysis

The numerator or Amount A in the specified value formula is $10, which is the fair market value at the time the original option was granted of a Company X share. Amount B, or the denominator, is .5 because one-half of a Company Y share could be purchased in lieu of one Company X share. The Company X share was worth $100 at the time of the exchange, while the Company Y share was worth $200. Therefore, a Company X share was worth .5 of a Company Y share. Therefore, the specified value of each Company Y share is $20 ($10 ÷ .5).

3. Revoked Election – 7(13)

New subsection 7(13) allows for the revocation of an election made in accordance with subsection 7(10) to defer recognition of a stock option benefit under subsection 7(8). In order for the revocation of the election to apply, the taxpayer must file a written revocation of the election with the person with whom the election was filed by January 15th of the year after the exercise of the option. Generally, this person would be the employer of the employee. (See the discussion of prescribed election for a list of the entities to which the revocation can be made.)

When an election is revoked in accordance with subsection 7(13), the election is deemed never to have been made. Therefore, the employment benefit associated with the exercise of the stock option is taxed in the year of exercise as opposed to the year of disposing of the share. More importantly, the "specified value" of the security, as defined in subsection 7(11), ceases to be relevant for the purposes of applying the $100,000 annual vesting limit discussed in paragraph 7(10)(c) to other stock option securities upon which the taxpayer may wish to defer taxation.

This is a very strong tax-planning tool. This allows a taxpayer to elect to defer something at the beginning of the year and then change his or her mind, depending on what happened during the rest of the year. In general, it also means that you should always elect to have the stock option benefit deferred during the year since you can change your mind by January 15 subsequent to the year.

The planning benefit would exist where options are exercised more than once in the year and the stock price increases at each option exercise.

See below for an example of where this election revocation would be of benefit.

Example

Facts

1. On May 31, 2001, the taxpayer's corporate employer grants him options to acquire 10,000 shares in the company.
2. The exercise price and fair market value is $10 per share.
3. The options vest immediately and expire on May 31, 2004.

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Example (cont'd)

4. On October 31, 2001, the taxpayer's employer grants him another 5,000 options.

5. The exercise price and fair market value of these options is $15 per share.

6. These options vest immediately and expire on October 31, 2004.

7. The taxpayer exercises all of the $10 options on May 31, 2004, when the fair market value is $100 a share.

8. The taxpayer exercises the remaining options on October 31, 2004, when the fair market value is $295 per share.

Analysis

If the taxpayer filed an election in May 2004 for the first set of stock options that were exercised, he would be able to defer the full stock option benefit of $900,000 (10,000 shares x $100 - $10). The full amount could be deferred because the specified value of these shares would be $100,000 (10,000 x $10). However, if this were done, the stock option benefit on the shares exercised in October of 2004 would not be able to be deferred. The stock option benefit for the October 2004 shares would be $1.4 million [5,000 x ($295 - $15)]. Therefore, the taxpayer would prefer to elect on the October 2004 options versus the May 2004 options.

The specified value of the stock options exercised in October would be $75,000 (5,000 x $15). Since the taxpayer would have used $100,000 of specified value on the May shares, the taxpayer could file with the employer a written request to revoke the election previously made on 7,500 of the $10 options. The net effect of the above is that $675,000 [7,500 shares x (100 – 10)] of stock option benefit income will be shown in the 2004 tax return. The remaining benefit of $1,625,000 will be deferred until the taxpayer disposes of the shares. The deferred benefit is calculated as follows:

May shares - 2,500 x ($100 - $10)	=	$225,000
October shares - 5,000 x ($295 - $15)	=	$1,400,000
		$1,625,000

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4. Deferral Deemed Valid – 7(14)

New subsection 7(14) contains rules to allow the Minister of National Revenue to treat an invalid deferral of a stock option benefit realized on the acquisition of a stock option security as a valid deferral under subsection 7(8).

This subsection is meant to be a relieving provision. It deals with situations where one of the two tests in subsection 7(8) are not met, such as:

a) the acquisition is not a qualifying acquisition; or

b) the taxpayer does not elect in accordance with subsection 7(10). This could mean that the election is either filed late; the taxpayer is not resident in Canada or the specified value exceeds $100,000.

On the assumption that the taxpayer thought that his or her election was valid, the taxpayer would not have recorded any stock option benefit up until such time as the Minister notified the taxpayer that the deferral was invalid. Instead of stating that the taxpayer should have reported the employment benefit at the time that the stock option was exercised, this section allows that the stock option benefit to be recognized in the year when the taxpayer received the notice from the Minister. If the taxpayer had already sold the shares, then the stock option benefit would have been recognized anyway. Therefore, this only applies to situations where the taxpayer still holds the security.

If the taxpayer does still hold the security, the taxpayer is deemed to have disposed of and reacquired the security immediately thereafter. However, the reacquisition is not under a stock option agreement. Therefore, any increase in value from that point onward would be treated as a capital gain.

This subsection also ensures that the $100,000 vesting amount is applied in the year when the security first became exercisable as opposed to the time when the Minister notifies the individual. This allows the individual to use an additional $100,000 specified value in any other year.

In the Technical Notes, it states that it is expected that the Minister would apply the provision of the subsection when the year in which the security was acquired is statute barred. It is not clear why they would say that, given that this subsection could apply for any year, even within the statute-barred period.

5. Ordering of Dispositions – Identical Properties

The ordering of the exercise of identical options and disposition of identical securities has been clarified by the addition of new subsections 7(12) and 7(1.31) and the amendment of 7(1.3). This is relevant in determining the income inclusion for a stock option. Without these subsections, a taxpayer would not be able to determine the order of disposition for shares acquired through stock options or shares purchased on the open market. As well, a taxpayer would not be able to determine if the stock options exercised qualify for the stock option deferral.

New subsection 7(12) deals with the order in which options are exercised.

Amended subsection 7(1.3) deals with the order in which identical shares acquired from stock options are deemed to be disposed of. Moreover, it has been amended so that these ordering rules are applicable for various sections of the Income Tax Act.

New subsection 7(1.31) allows for a taxpayer to not use the rules of amended subsection 7(1.3) and to designate the order of disposition of shares acquired through stock options. Below is a more detailed discussion of each of the subsections mentioned above.

a) Identical Options – Order of Exercise - 7(12)

The ordering of the exercise of identical options is as follows:

i) where the taxpayer has designated an order, in the order so designated; and

ii) in any other case, in the order in which the options first became exercisable and, in the case of identical rights that became exercisable at the same time, in the order in which the stock option agreements under which those rights were acquired were made.

This means that, for identical options that became exercisable at the same time, but were granted at different times, the options are considered to have been exercised in the order in which they were granted.

However, the taxpayer has the ability to designate the order of exercise. The ability to determine the order of exercise of identical options is a significant planning tool. It allows the taxpayer to choose an order that allow him/her to defer the maximum stock option benefit possible.

The example below contrasts the stock option benefit that would be included in income if no designation were made compared to the stock option benefit if the taxpayer made the designation.

Example

Facts

1. June 1, 2001 – 20,000 options granted with an exercise price and fair market value of $10 a share.
2. Half of options vest immediately; the other half vest on June 1, 2002.
3. On June 1, 2002, another 20,000 options are granted with an exercise price and fair market value of $10.
4. Half the options vest immediately; the other half on June 1, 2003.
5. On June 1, 2006, 30,000 options are exercised. FMV = $100.

Analysis

If no designation is made, then the options are considered to be exercised as follows:

1. 10,000 options that vest on June 1, 2001;
2. 20,000 options that vest on June 1, 2002 (10,000 were granted in 2001 and 10,000 were granted in 2002).

The specified value of the options that vested in 2001 would be $100,000 ($10 x 10,000 shares). Since the total specified value of the options that vested in 2001 is $100,000, the full employment benefit on those options can be deferred under subsection 7(8).

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Example (cont'd)

Analysis (cont'd)

The total specified value of the option that vested in 2002 is $200,000 (10,000 options granted in 2001 at $10 and 10,000 options granted in 2002 at $10). Since the total specified value is greater than $100,000, the maximum that could be deferred would be on half of the options. Therefore, the stock option benefit included in income would be $900,000 [10,000 shares x (100 - 10)].

<u>Planning Alternatives</u>

In order to maximize the deferral available, the taxpayer could have designated that the following options were exercised:

1. 10,000 options that vested on June 1, 2001;

2. 10,000 options that vested on June 1, 2003

3. 10,000 of the 20,000 options that vested on June 1, 2002.

By using these designations, the specified value would have been $100,000 for each vesting year. Therefore, the entire employment benefit on the exercise of those options exercised in 2003 could have been deferred until the disposition of those shares. When, however, the remaining 10,000 options that were granted on June 1, 2002, are exercised, no stock option deferral will be available.

It is important to note that the designation permitted under this subsection may be used in respect of options exercised <u>before</u> February 28, 2000. This will allow for a deferral, which might not otherwise be allowed on options exercised after February 27, 2000.

The example below details how those identical options exercised before February 2000 must be considered in calculating the stock option benefit on identical securities exercised after February 2000.

Example

Facts

1. Options are granted in 1996 that have a total specified value of $400,000. One half of these options vested in 1997 and the other half in 1998.

2. In 1999, half of the options are exercised.

3. In July 2000, the other half is exercised.

Analysis

If no specific designation were made, the options exercised in 1999 would have a specified value of $200,000 relating to the options that vested in 1997. For 2000, the options would have a specified value of $200,000 for the options that vested in 1998. Therefore, half of the employment benefit on the options that were exercised in 2000 would be able to be deferred. The other half would be taxable in the year that the options were exercised.

Planning

If, however, the taxpayer chooses to designate half of the options that vested in each of 1997 and 1998 as the options, which were exercised in 1999, then the taxpayer could designate the remaining options as the options, which were exercised in July 2000. Therefore, for the options that were exercised in 2000, the specified value of those options that vested in 1997 would be $100,000 and the options that vested in 1998 would also be $100,000. Therefore, since each of these specified values for the 1997 and 1998 year did not exceed $100,000, the entire stock option benefit in 2000 could be deferred.

This is a significant point that must be reviewed each and every time that a stock option is exercised.

b) Order of Disposition of Securities – Identical Properties – 7(1.3)

Subsection 7(1.3) provides a rule for determining the order in which a taxpayer disposes of shares that were acquired from stock options that are identical property. Before the proposed amendments were tabled, this subsection only dealt with the order in which CCPC shares that were acquired through stock options were disposed of.

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In general, subsection 7(1.3) deems the employee to have disposed of identical shares in the order in which the employee acquired them, i.e., on a first-in-first-out basis.

The new amendments state that this new subsection also applies for the purposes of the following:

i) Subsection 7(8);

ii) Subdivision (c);

iii) Subparagraph 110(1)(d.1)(ii);

iv) Subsection 147(10.4).

(i) I will look at each of these changes separately.

i) Subsection 7(8)

As stated above, subsection 7(8) allows for the deferral of the employment benefit of certain non-CCPC stock options. The extension of the application of subsection 7(1.3) to subsection 7(8) allows for the determination of when a particular security has been disposed of and, consequently, when the employment income associated with that stock option should be recognized.

ii) **Subdivision (c)**

Subdivision (c) sets out the rules for determining taxable capital gains and allowable capital losses when a taxpayer disposes of capital property. The extension of subsection 7(1.3) to subdivision (c) ensures that the security that the taxpayer is considered to have disposed of for the purposes of the employment benefit provisions in section 7 is also the security that the taxpayer is considered to have disposed of for purposes of capital gains when the security disposed of is identical to other securities owned by the taxpayer.

iii) **Subparagraph 110(1)(d.1)(ii)**

This paragraph allows for the deduction of a portion of the employment benefit that is calculated pursuant to section 7. This subparagraph requires that the share not be disposed of within two years of acquiring it in order to qualify for the deduction. Extending the application of subsection 7(1.3) to subparagraph 110(1)(d.1)(ii) ensures that a determination can be made as to when a particular security that was acquired under a CCPC option was disposed of and whether or not the taxpayer has satisfied the two-year hold requirement where the taxpayer holds identical shares.

iv) **Subsection 147(10.4)**

This subsection deals with the deferred profit-sharing plan and is beyond the scope of this paper.

Another amendment to subsection 7(1.3) provides two rules for determining, for the purposes of that subsection, the order in which identical securities are considered to have been acquired. New paragraph 7(1.3)(a) provides that, where a taxpayer acquires identical securities that are not "deferral securities," then new securities are deemed to have been acquired immediately before the earliest acquisition of the deferral securities. Deferral securities are securities that were acquired under circumstances to which any of subsections 7(1.1) or (8), or subsection 147(10.1) applied. These are the CCPC deferral, public company deferral and deferred profit-sharing deferral sections, respectively.

When looking at this new rule in conjunction with the ordering rule for dispositions, a taxpayer holding both deferral and non-deferral securities is considered to dispose of the non-deferral securities first. It is crucial that detailed records are kept so that a determination can be made as to which security would be deemed to have been disposed of first.

Paragraph 7(1.3)(b) provides that when a taxpayer acquires a number of identical deferral securities at one time, the securities are deemed to have been acquired in the order in which the options under which the securities were acquired were granted. Therefore, in conjunction with the ordering rule for dispositions, the effect of the deeming rule is that a taxpayer who acquires identical securities, under different options, at the same time is considered to have disposed of those securities in the order in which the relevant options were granted.

The amendments to subsection 7(1.3) also state that the subsection is subject to subsection 7(1.31) and paragraph 7(14)(c). We will now look at the effect of each of these subsections.

(1) New Subsection 7(1.31)

This subsection contains a special rule allowing a taxpayer to designate the most recently-acquired security as a security being disposed of when a security that is identical to other securities is disposed of. Certain conditions must be met, which will be discussed later in this paper.

(2) Subsection 7(14)(c)

As stated above, this subsection allows the Minster of National Revenue to treat an invalid deferral of an employment benefit as a valid deferral under proposed subsection 7(8) by sending a written notice to the taxpayer. Paragraph 7(14)(c) deems the taxpayer to have reacquired the security immediately after that time, but not under an employee option agreement. Therefore, the security is treated, from that point on, for the purposes of the ordering rule in subsection 7(1.3) as a non-deferral security. See below for a discussion of the calculation of the cost base as per new subsection 47(3).

Amended subsection 7(1.3) applies to securities acquired after February 27, 2000. It also applies to securities acquired, but not disposed of, before February 28, 2000.

c) Disposition of Newly-Acquired Securities – 7(1.31)

This new subsection allows a taxpayer to not follow the rules in subsection 7(1.3) and to deem a particular security to be security that is the subject of a disposition. In order for the taxpayer to be able to designate which security is disposed of, five conditions must be met:

i) The security must have been acquired under a stock option agreement described in subsection 7(1).

ii) The disposition must occur no later than 30 days after the taxpayer acquired the particular security.

iii) There must be no other acquisitions or dispositions of identical securities in the period between the acquisition of the security and the disposition of the security. This does not mean that a taxpayer cannot acquire other securities at the initial time of acquisition or dispose of other securities at the time of disposition. Therefore, this section will apply to a portion of the securities acquired and disposed of at a particular time.

iv) The taxpayer must make the designation in the return of income that is filed for the year in which the disposition occurs. At this point, there is no specific form that is required to be filed in order to make the designation. It is expected that the Minister of National Revenue will accept, as the form of designation, the calculation of the capital gain or loss in the taxpayer's tax return; and

v) The taxpayer must not have designated the particular security in connection with the disposition of any other security.

See below for an example of what the results are when a designation is made pursuant to subsection 7(1.31).

Example

Facts

1. On May 1, 2000, 1,000 shares of Company A are purchased on the open market.

2. On May 1, 2001, 1,000 shares of Company A are purchased on the open market.

3. On May 1, 2002, 2,000 shares are acquired under an employee stock option agreement.

4. May 31, 2002, 1,500 shares are sold.

Analysis

In the taxpayer's tax return for 2002, he designates the 1,000 stock option shares as constituting part of the shares that were sold. Therefore, pursuant to subsection 7(1.3) and 7(1.31), the 1,500 shares being sold are comprised of the following:

1. 1,000 stock option shares; and

2. 500 of the 1,000 shares that were acquired on the open market on May 1, 2000.

Otherwise, the 1,500 shares sold would be the shares purchased on the open market only. This designation may make sense when a taxpayer has significant deductions and he or she would prefer employment income to capital gains.

Please see the discussion below on the calculation of the adjusted cost base, pursuant to new subsection 47(3). This subsection applies to securities after February 27, 2000 and securities acquired but not disposed of before February 28, 2000.

6. Exchange of Options – 7(1.4)

Subsection 7(1.4) allows for a taxpayer to exchange stock options and not be taxed on that transaction. Without this subsection, section 7 would deem certain exchanges of options to be taxable transactions. Subsection 7(1.4) accomplishes this by deeming the exchange not to have occurred at all for the purposes of section 7.

This deeming provision would cause problems with the proposed new subparagraph 7(9)(d)(ii) because, in that subparagraph, it states that if the employee had received the option in exchange for other options, then the new option could still be eligible for the stock option deferral. The problem is that, as stated above, subsection 7(1.4) currently states that the exchange did not occur. Therefore, in order to fix this discrepancy, there is an amendment to subsection 7(1.4) that states that the exchange did occur only for the purposes of subparagraph 7(9)(d)(ii).

7. Rules Where Securities Exchanged – 7(1.5)

Subsection 7(1.5) deems a qualifying exchange of shares acquired under a stock option not to be a disposition for the purposes of subsection 7(1.1) and new subsection 7(8). The new shares are deemed to be a continuation of the old shares. In this way, there is no taxation of the employment benefit that would normally be associated with a disposition of shares. In order to qualify, there are three conditions that must be met:

a) the exchange must be for shares of a corporation within the corporate group (including corporations formed on an amalgamation or merger);

b) the employee must receive no consideration for the disposition of the old shares other than the new shares;

c) the value of the new shares must be no greater than the value of the old shares.

Subsection 7(1.5) is amended so that it applies for the purposes of new paragraph 110(1)(d.01), which allows the special deduction in computing income when an employee donates an employee option security acquired after February 27, 2000 to a qualifying charity (please see below for a discussion of stock option donations). These changes to subsection 7(1.5) ensures that the special deduction for employee donations is not lost if the employee exchanges the option security for another qualifying security and donates the new security to charity.

One of the other amendments to subsection 7(1.5) is paragraph (e), which deems the new securities to be the same securities as, and a continuation of, the old securities does not apply so as to deem the new securities to be identical to securities to which they would not otherwise be identical. This ensures that the rules in subsections 7(1.3) and (1.31) discussed above, which deem identical securities to be disposed of in a particular order, do not apply to identify a particular security as the security disposed of unless the security is, in fact, identical to the security that is the subject of the disposition. For example, if an individual owned two types of shares in Company A, and only one of those types of shares was converted into shares of Company B, then the Company B shares and old Company A shares would not be considered to be identical properties.

Special Situation – Deferral & Capital Gain

There may be situations where a taxpayer is able to defer the employment benefit on a stock option exchange, but not a capital gain. If, for example, a Canadian company exchanged its shares for those of a U.S. company, subsection 7(1.5) would allow for the continued deferral of the stock option employment benefit. However, for capital gains purposes, there could be a capital gain. In order to ensure that a taxpayer is not taxed twice on the same amount, the employment benefit amount, even though not realized as income, is added to the cost base of the share, pursuant to paragraph 53(1)(j) for the purposes of calculating the capital gain on the share exchange.

8. Calculation of Adjusted Cost Base – 47(3)

Subsection 47(1) requires that the cost of identical properties be averaged over all such properties. In other words, each property within a group of identical properties will have the same cost base. However, new subsection 47(3) exempts certain securities acquired after February 27, 2000 from the cost averaging rule. The new subsection deems such securities not to be identical to any other securities acquired by the taxpayer for the purposes of subsection 47(1). Subsection 47(3) applies to the following securities:

a) Securities acquired under a stock option agreement for which a deferral is provided either under subsection 7(1.1) (CCPC shares), or new subsection 7(8) (public company shares). The subsection also applies to securities acquired in exchange for other securities under circumstances to which subsection 7(1.5) applies.

b) Securities acquired under a stock option agreement where the securities are designated by the taxpayer and deemed by new subsection 7(1.31) to be the securities that are the subject of a disposition of identical properties occurring within thirty days after the acquisition.

c) Shares received as part of a deferred profit-sharing plan. This subject is beyond the scope of this paper.

The effect of subsection 47(3) is that the securities to which the subsection applies are not included in the calculation of cost base for other identical properties. Each security to which subsection 47(3) applies has its own unique adjusted cost base. As discussed above, subsection 7(1.3) deems a taxpayer to dispose of deferral securities only after having disposed of non-deferral securities. The deferral securities are then disposed of in the same order in which they were acquired. Therefore, it is possible to determine, when a particular security to which subsection 47(3) applies, is disposed of, and what its ACB is. Again, it will still be very important that detailed records are kept of all stock option and share transactions.

9. Withholding Taxes – 7(15)

Where a taxpayer is deemed to have received a benefit from employment in a taxation year that is deferred because of section 7(8), the benefit is deemed to be nil for the purposes of withholding taxes under subsection 153(1). There is considerable controversy as to what withholdings, if any, must be made once the stock option benefit is taxable.[5]

10. Disposal of Stock Options – 7(1.7)

One of the other new rules that was brought in has nothing to do with the stock option deferral rules. Instead, this subsection was brought in because the government lost a case called "*Buccini.*"[6] This was a case decided by the Federal Court of Appeal. In this case, an individual became employed with a company and entered into a stock option agreement,

[5] See Memos 9821967 and 9731576 from CCRA. In both of these memos, they refer the taxpayer to the "Source Deductions Division" and do not give an answer.

which could not be exercised until after two years of continuous employment. In the following year, however, the company merged its subsidiaries. On consummation of the amalgamation, all outstanding options to purchase stock were to be terminated. The parent company did not want any minority shareholders. The taxpayer did not consent to the termination of his options. The taxpayer and the company executed a settlement agreement, which acknowledged that payment of $83,900 was in full settlement of all claims arising from the company's unilateral termination of the stock option agreement. The taxpayer reported the release payment as damages for unilateral breach of agreement. The CCRA had included the amount received as income pursuant to paragraph 7(1)(b).

In the Tax Court of Canada, the Minister won its case to include the amount as originally assessed. The trial judge held that the amounts received from the release were in essence a disposition of the taxpayer's right under the agreement and consideration for payment. The Federal Court of Appeal overturned the trial judge's decision and stated that the trial judge failed to recognize that the amalgamation of the companies constituted a unilateral repudiation of the taxpayer's rights under the agreement and, as a result, the taxpayer could not be found to have disposed of these same rights, pursuant to paragraph 7(1)(b). In other words, the source of the payment was not really the stock option agreement but rather the unilateral repudiation of that stock option agreement.

As a consequence of the above, the Court held that the amount was not taxable and was sent back to the Minister for reassessment.

In response to this, the Department of Finance created new subsection 7(1.7). In this subsection, it states that where a taxpayer receives amounts in respect of stock options that cease to be exercisable and this cessation would not constitute a transfer or disposition, then the taxpayer is deemed to have a disposition and to have received those amounts as consideration of the disposition. This deeming paragraph means that any funds received in a situation like this would now be taxable under paragraph 7(1)(b). In other words, if the transaction does not result in a disposition, such as in the *Buccini case*, the Income Tax Act

[6] *Buccini vs. M.N.R. (2000 DTC 6685).*

would deem there to be a disposition. The message in this is that if you lose a case in the Courts that the government does not like, they will change the law.

11. 110(1)(d) Deduction

Paragraph 110(1)(d) provides a deduction in computing taxable income when there is a subsection 7(1) deemed employment benefit from the exercise of a stock option. The deduction available is one-half of the employment benefit.

There are three tests that must be met in order to be able to claim this deduction. In general terms, the three tests are:

a) An exercise test;

b) An arm's length test; and

c) The security must be a prescribed share.

The third test has not been amended, but the two other tests have been. The changes are as follows:

a) Exercise Price Test

This paragraph has been substantially amended in subparagraph (iii). This paragraph applies when the option being exercised or disposed of was acquired by the employee as a result of one or more exchanges of options in accordance with subsection 7(1.4). The subparagraph is amended to require that the following conditions be satisfied:

i) The exercise price under the original option at the time it was exchanged must not be less than the fair market value of the underlying security at the time the option was first granted, minus any amount paid by the employee to acquire the option.

ii) For each subsequent exchange, the closing exercise price of the option being given up must not be less than the exercise price that was set under that option when it was first granted.

iii) For the option which is being exercised or disposed of and is giving rise to the employment benefit, the exercise price at the time of exercise or disposition must not be less than the exercise price that was set under the option when it was first granted.

In general terms, the exercise price of each subsequent stock option received cannot be less than the original exercise price of the original stock option.

There are a number of very detailed calculations to determine whether or not an employee has derived an economic gain from the exchange of options. This, however, is beyond the scope of this paper.

b) Arm's Length Test

The arm's length test is amended in two ways:

i) Rather than having to be at arm's length with the grantor of the stock option and any entity not dealing at arm's length with the grantor, the employee must now be at arm's length with the grantor, the employer and the entity whose securities can be acquired under the option. Therefore, there are fewer people with whom the employee must be at arm's length in order to claim the section 110 deduction.

ii) Where there has been an exchange of options under subsection 7(1.4), the arm's length test is applied with respect to the original option and not with respect to any subsequent exchange of options. Therefore, if the nature of the relationship changes subsequent to the initial granting of the option, then the arm's length test can still be met.

All of these amendments apply to the 1998 and subsequent taxation years.

12. Charitable Donation of Stock Option Shares – 110(1)(d.01)

If an employee donates a security to a qualified donee, new paragraph 110(1)(d.01) allows an employee to deduct a portion of the employment benefit that the employee is deemed by subsection 7(1) to have received in connection with the acquisition of the security under a stock option. A qualified donee generally means a person to whom gifts can be made that qualify for the charitable donations tax credit or deduction.

One of the other conditions is that the taxpayer is entitled to a deduction under paragraph 110(1)(d). As stated above, this would mean that the taxpayer would have to meet certain tests with regard to the type of security, the arm's length test, and the exercise price test.

Another condition is that the gift must be made in the year and on or before that day that is thirty days after the day on which the taxpayer acquired the security.

The last condition is that the taxpayer must have acquired the security after February 27, 2000 and before 2002.

The deduction, pursuant to this subsection, is one-quarter of the stock option benefit. When combined with the regular deduction in paragraph 110(1)(d) of one-half, the total deduction would be three-quarters, which is the same as the capital gains rules in paragraph 38(a.1).

One other new subsection of note with regard to charitable donations is 110(2.1). This subsection allows an employee to claim the deduction discussed above where the employee exercises a stock option and directs a broker or dealer to sell the security immediately and donate all or part of the proceeds of the disposition to a qualifying charity. Therefore, it is possible to exercise the option and donate the proceeds as opposed to donating the stock option. This allows for some kind of flexibility when dealing with the charity.

13. Discussion/Analysis

a) Are Options the Best Way to Reward Our Employees?

The government has attempted to make the rules more in line with the U.S. and to also make them less punitive on those who received public company stock options. The main reason that the government made any move was the fact that the stock market was increasing on a regular basis and people were making significant amounts of money through the exercise of stock options. The stock market is now in a decline not seen in a decade. Most of the stock options that were granted in the late 90's and early 2000 are virtually worthless. Therefore, the attractions of stock options have declined.

The rules that the government introduced were meant to deal with an increase in share prices. The government failed to fix one of the most punitive results of stock options. If a stock option is exercised and the share is held and then sold at a loss, there is no relief for that loss. The loss is a capital loss and the stock option benefit is employment income. Since capital losses can only be offset against capital gains, the net effect is that there is employment income upon which taxes are payable and a capital loss that can be used in the future.

Example

Facts

1. Exercise price of stock option - $10
2. Jan 2000 – 1,000 option exercised – fmv - $100
3. Dec 2000 – 1,000 stock sold – fmv - $15

Analysis

Employment income - [1,000 shares x (100 – 10)] - $90,000	
Capital Loss – [1,000 shares x (15 – 100)] -	($85,000)
Net benefit from options -	$5,000
Taxes payable – (50% x $90,000)	$45,000
Net cash position	($40,000)

The government needs to develop a way so that the loss on the eventual sale of the share can be offset against the employment benefit. Since the government has brought in rules that will allow for the deferral, it will be simple to determine the loss, if any, on the disposition of the share, which could offset the employment benefit.

Since stock options have become unattractive, most companies have gone back to the old-fashioned way of rewarding employees – cash. More and more employees are requesting cash bonuses as opposed to stock option bonuses. Until the government provides relief for the downturn in stocks as well as the upturn, companies and employees will be hesitant to continue the use of stock options.

14. Conclusion

There are still a number of significant stock options in existence upon which all of the new rules discussed above will have to be applied. In order to apply any rules, it will be crucial that the professionals have all of the information available to them in order to make a decision as to how best to defer the stock option benefit. This may be the biggest challenge of the new rules as it is often difficult to accumulate this information.

In any case, these rules are a step in the right direction and we can only continue to hope that the government will eventually make the rules fair for decreases in value.

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