

# Incentives and Benefits

This regular feature is edited by Dov B. Begun, of Osler, Hoskin & Harcourt LLP. It examines major trends and tax planning issues pertaining to executive incentive and benefit plans and arrangements.

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## STOCK OPTIONS

# Imperial Tobacco: Deductibility of Stock Option Cash-out Payments Denied in the Course of Corporate M&A

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## Introduction

On November 10, 2011, the Federal Court of Appeal delivered its unanimous decision in *Imperial Tobacco*,<sup>1</sup> and denied the taxpayer, Imasco Limited, a tax deduction in respect of Imasco's payment of approximately \$118 million to cash out employee stock options. The Court found that paragraph 18(1)(b) of the Income Tax Act<sup>2</sup> applied to deny the tax deduction on the basis that the expenditures were on capital account because they were made in the context of a going-private transaction of Imasco and extinguished all of the outstanding obligations of Imasco to issue shares. The decision comes as a disappointment to many who had hoped that the Federal

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<sup>1</sup> *Imperial Tobacco Canada Limited (Successor by Amalgamation to Imasco Limited) v. The Queen*, 2011 FCA 308. Application for leave to appeal to the SCC was filed on January 9, 2012.

<sup>2</sup> R.S.C. 1985, c. 1 (5th Supplement), as amended.

Court of Appeal would take the opportunity to take a more "common sense" approach to the deductibility issue. This article discusses the principles to be derived from the *Imperial Tobacco* case and considers the implications the reasoning therein may have on the deductibility of other expenses, including outside of the stock option context.

## Background

The factual background underpinning *Imperial Tobacco* and its companion case, *Shoppers Drug Mart*,<sup>3</sup> has been discussed in other articles in this publication and elsewhere<sup>4</sup> and, consequently, is described herein only at a high level. In essence, Imasco, a public corporation, implemented a stock option plan, which had been in place since 1983, for its employees and for employees of several of its subsidiaries, including Shoppers Drug Mart. In 2000, a significant shareholder of Imasco made a bid to acquire all of the issued and outstanding shares of Imasco and, as part of the negotiations surrounding this going-private transaction, it was agreed that the vesting of all employee stock options would be accelerated, and employee option-holders given the opportunity to surrender their options for cash. A significant majority of Imasco, Shoppers Drug Mart and other participating employees surrendered their options for cash rather than exercising them for shares.

Pursuant to reimbursement arrangements in place, Shoppers Drug Mart reimbursed its parent Imasco for the cash payments made to employees of Shoppers who surrendered

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<sup>3</sup> *Imperial Tobacco Canada Limited (Successor by Amalgamation to Shoppers Drug Mart Limited) v. The Queen*, 2007 TCC 308. Interestingly, this case was not appealed to the Federal Court of Appeal.

<sup>4</sup> See, for example, Anu Nijhawan and David Mercier, "Imperial Tobacco Canada Limited v. R.: Re-opening the Debate on the Deductibility of Stock Option Cash-Out Payments in the Court of Corporate M&As" (July/August 2007) 19 *Taxation of Executive Compensation and Retirement* 859; Paul Carezza and Michael Platt, "Imperial Tobacco: Stock Option Plans and Cash-Out Payments" (December/January 2011) 22 *Taxation of Executive Compensation and Retirement* 1360; and Anu Nijhawan and Steven Sieker, "Topical Issues in Equity-Based Employee Compensation," *Report of Proceedings of the Sixtieth Tax Conference*, 2008 Tax Conference (Toronto: Canadian Tax Foundation, 2009), 15:1-36.

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options and, in 2007, the Tax Court upheld the deductibility of the reimbursement payments made by Shoppers, largely on the basis of a “common sense” approach and on the fact that the capital structure of Shoppers was not, itself, changed as a consequence of the transactions. In view of the previous case law<sup>5</sup> and the Canada Revenue Agency’s long-standing position, the decision came as something of a surprise, but also as a welcome development for employers that were making cash-out payments to employees in the course of a takeover or other capital reorganization. In 2010, the Tax Court considered the deductibility of the cash payments by Imasco to its own employees and, notwithstanding the *Shoppers Drug Mart* case, denied the deduction. It is this latter decision that was the subject of the appeal in *Imperial Tobacco*, wherein the Federal Court of Appeal confirmed the non-deductibility of the payment.

### Principles in Imperial Tobacco

In coming to the view that the cash payments made by Imasco were on account of capital, the Federal Court of Appeal pointed to three key factors:

- the payments coincided with a reorganization of the capital of Imasco (i.e., the going-private transaction);
- the arrangements put in place for making the payments facilitated and were intended to facilitate the capital reorganization; and
- the payments were intended to and did end all future obligations of Imasco to deal with its own shares, which could, in the Court’s view, be fairly described as a once-and-for-all payment that resulted in a benefit to Imasco of an enduring nature.

The Court did acknowledge the factors in favour of Imasco’s argument that the payments in issue were best described as employee compensation and therefore deductible as ordinary business expenses. The first was that the employee stock option plan was designed and intended to be a form of employee compensation, and that Imasco had in the past made similar payments to employees as compensation for surrendering stock options.

<sup>5</sup> Notably, *R. v. Kaiser Petroleum Limited*, 90 DTC 6603 (F.C.A.) and *Canada Forgings Ltd. v. The Queen*, 83 DTC 5110 (F.C.T.D.), discussed in the articles noted *ibid*.

Second, the shares of Imasco represented by the cancelled options represented only a very small portion of the shares (just over 1%). Notwithstanding these factors, the Federal Court of Appeal agreed with the conclusion of the Tax Court that they were of insufficient weight to overcome the factors in support of the capital characterization.

In its discussion of the deductibility issue, the Federal Court of Appeal also questioned the decision in *Shoppers Drug Mart*, indicating that, while it is “arguable” that a payment made by a corporation on the surrender of employee stock options is deductible employee compensation, it doubted that it would have concluded that that was the situation in *Shoppers Drug Mart*. While the Court explicitly refrained from expressing a final opinion on the point, the comments raise some question about the validity of the decision in *Shoppers*.

The Court also rejected Imasco’s argument that the *Kaiser* decision, a 1990 decision denying deductibility of stock option cash-out payments in the course of a capital restructuring, should not be followed because it was not in step with current economic realities. In particular, the Court found no reason to conclude that the “greater use of employee stock option plans, in and by itself, should mean that a transaction like the one considered in *Kaiser* is not on capital account.”

### Implications of Imperial Tobacco

The decision in *Imperial Tobacco* has been appealed to the Supreme Court of Canada. Subject to the result of any such appeal, the Federal Court of Appeal’s decision indicates that it will be difficult for taxpayers to successfully claim a deduction for a cash-out payment made in the context with a capital transaction such as an amalgamation, takeover, or going-private transaction. The questioning by the Court of the result in *Shoppers Drug Mart* may mean that a deduction will be denied even if there is no direct impact to the capital structure of the employer corporation but a related capital transaction nevertheless exists. The Court’s focus seems to be on the nature of the transaction that precipitates the making of the payments – not on the fact that the underlying reason for the payments is compensation for services rendered. In all cases, where a tax

deduction is sought, it will be incumbent on the taxpayer to convince the court that the cash-out payment was not designed to "facilitate" a capital transaction. How future courts will interpret and apply this vague standard is debatable.

Perhaps even more significantly, the Court appears to question whether any stock option cash payment is deductible even outside of the reorganization context, stating that such deductibility is only an "arguable" position. One can only hope that this statement is read narrowly as applying only in the factual context of the *Imperial Tobacco* decision. It is clearly an unacceptable result if all stock option cash-out payments are rendered non-deductible as a consequence of the Federal Court of Appeal's decision. We would argue that, where a cash surrender payment is made independent of any extraordinary transaction, those payments should continue to be deductible – as there is no underlying capital transaction at issue.

In many situations, the issue of deductibility may no longer be as large a factor as it once was, given that, as a result of the 2010 budget changes to the stock option rules, it is no longer possible for stock option surrenders to generate both capital-gains like treatment for optionholders and a corporate deduction for the employer. Rather, the employer must choose one or the other. In the course of many transactions, it is assumed that most

employers will wish to optimize their employees' tax treatment and thus will elect to forego the tax deduction associated with a cash-out payment. If this assumption is correct, the *Imperial Tobacco* decision may have relatively limited impact even if it is not reversed on appeal. The issue will remain, however, prominent in the case of stock option surrender payments made in connection with past takeovers which are currently under review by the Canada Revenue Agency.

In addition to the foregoing, it is possible that the *Imperial Tobacco* decision could have implications even outside of the stock option context. For example, where a corporation undertakes to pay bonuses to its employees in connection with the successful completion of a capital transaction (e.g., a corporate takeover), query whether the three factors articulated by the Federal Court of Appeal could be used to support an argument by the Canada Revenue Agency that such bonuses are non-deductible, in that the payment of such bonuses is also coincident with and intended to facilitate the capital transaction. Similar concerns could arise where a corporation pays severance payments to employees whose employment is terminated as a consequence of the completion of a capital transaction. We would contend that any argument that such amounts are non-deductible should not be successful, but taxpayers should be cognizant of the concerns raised in this regard by the *Imperial Tobacco* case.