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STOCK OPTIONS

Morin v. The Queen: Non-traditional Employee Recruitment Fees May Reduce Section 7 Benefits

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The recent decision of the Tax Court of Canada in Morin v. The Queen[1] illustrates a potential avenue for employees who receive stock options as part of their compensation packages to convert otherwise non-deductible recruitment and placement fees into amounts that can offset benefits realized pursuant to section 7 of the Income Tax Act.[2]

In Morin, the taxpayer, M., an individual seeking employment in the high-tech sector, entered into an agreement with a headhunter, BCo, whereunder BCo agreed to find M. financially rewarding employment in exchange for a payment by M. to BCo of "a portion of any stock option or similar compensation or benefit package" that M. obtained. As a result of the arrangements, M. met with several potential employers from a list provided by BCo and ultimately accepted a position with a corporate employer where his remuneration package included employee stock options. M. exercised the stock options in 2000 and 2001,[3] sold the shares of the employer through a broker and paid BCo its share of the proceeds.

BCo filed its tax returns for the years in question on the basis that the amounts paid to it by M. were consulting fees. The issue before the Tax Court was the appropriate treatment of such amounts to M. In filing his tax returns for the years in question, M. claimed that the amounts paid to BCo (aggregating in the amount of approximately $133,000) were an "amount ... paid ... to acquire the [stock option]" within the meaning of subparagraph 7(1)(a)(iii).

In general terms, where an employee acquires shares of an employer corporation pursuant to the exercise of an employee stock option, the value of the taxable benefit is computed as the difference between the value of the shares at the time of acquisition (subparagraph 7(1)(a)(i)) and the exercise price paid to the corporate employer for the shares (subparagraph 7(1)(a)(ii)) and the amount paid by the employee to acquire the right to acquire the securities (subparagraph 7(1)(a)(iii)). Thus, any amount paid to BCo which could be claimed by M. as falling within subparagraph 7(1)(a)(iii) would have the effect of reducing the taxable benefit to M. on the exercise of the stock options by a like amount.

The Minister argued that the amounts paid to BCo were properly characterized as fees paid for recruitment services, and not subparagraph 7(1)(a)(iii) amounts because the amounts were not paid directly to the corporate employer providing the stock options.[4] Although not discussed in the decision, it appears that the result of such position was that M. was not able to deduct the amounts paid to BCo in computing its income, pursuant to subsection 8(2).

Relying on a plain meaning approach to the interpretation of subparagraph 7(1)(a)(iii), the Tax Court

found in favor of M. Utilizing a dictionary meaning of the word "acquire" as meaning "to gain possession or control of," the Court held that the term, as used in subparagraph 7(1)(a)(iii), was not restricted to a situation where an amount is paid in exchange for legal title to the stock options. The Court also noted that, unlike subparagraph 7(1)(a)(ii), subparagraph 7(1)(a)(iii) is not limited to amounts paid to the corporation granting the stock option. Applying such an interpretation to the facts before it, the Court held that the amounts paid by M. to BCo were "directly related" to M. acquiring the stock options and thus could be said to be consideration for the acquisition of the right to acquire shares.

Based on Morin, subparagraph 7(1)(a)(iii) should be interpreted broadly so as to include any expense "directly related" to the acquisition of the options, including payments to third parties who assisted the employee to get the employment.

While Morin may in the future be limited to its particular facts, the decision should be of potential interest to anyone who contracts with a placement agency to assist in procuring employment. Recruitment or placement fees paid directly by the employee to the placement agency are generally rendered non-deductible pursuant to subsection 8(2). Further, even where the employer pays such placement fees directly on behalf of the employee, the amount may be required to be included in the employee's income as a taxable benefit pursuant to paragraph 6(1)(a) where, if the employer had not made the payment, the employee would have been obliged to.[5] In contrast to such a situation, however, where the agreement with the placement agency provides not for a traditional placement fee but rather a percentage of any stock option benefit, the taxpayer employee may be able to rely on Morin to obtain some indirect tax relief for the cost of such payment.[6]

[1]2005 DTC 813 (TCC – General Procedure).

[2] R.S.C. 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the "Act." Unless otherwise stated, statutory references in this article are to the Act.

[3]Although the facts of the case are not clear, it appears such exercise was done is a cashless manner through an independent broker.

[4] This is similar to the view of the Canada Revenue Agency (the "CRA") that transaction fees (e.g., commissions and brokerage fees) paid to a broker or other plan administrator do not represent the cost of acquiring an option under subparagraph 7(1)(*a*)(iii) or an amount paid for a security as contemplated by subparagraph 7(1)(*a*)(ii).

[5] See *Bure v. The Queen*, 2000 DTC 1507 (TCC – General Procedure) (Notice to Appeal to the Federal Court of Appeal filed but appeal subsequently dismissed for reasons of delay).

[6] Where such a clause was included in the placement contract for the main purpose of circumventing subsection 8(2), the potential application of the general anti-avoidance rule in section 245 would need to be considered.

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