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STOCK OPTIONS

Repricing Underwater Stock Options Tax-efficiently

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Introduction

Notwithstanding the thus far bumpy "recovery" of the Canadian stock market since the fall of 2008, many employees of Canadian public corporations continue to hold stock options which are "underwater" – i.e., which have an exercise price that is greater than the fair market value of the underlying shares. In such circumstances, talk of "repricing" options circulates amongst various boardrooms. While many institutional and other investors are philosophically opposed to repricing strategies, the issue remains a thorny one as underwater options arguably no longer fulfill their original purposes of encouraging employees to maximize shareholder value or of employee retention.

Once, however, a decision is made to implement a repricing, the critical concern, from a tax perspective, is typically to ensure that the optionholder continues to be eligible for the 50% deduction provided for by paragraph 110(1)(*d*) of the Income Tax Act [1] on the exercise of the option, which provision generally requires, amongst other things, that the exercise price payable under the option be not less than the fair market value ("FMV") of the underlying security at the time the option agreement was made. Fortunately, however, the rules in the Act, including those recently reintroduced in July 2010,[2] permit the preservation of such "capital-gains like" treatment on the repricing of options.

Absent a cancellation of existing underwater options and an unrelated grant of new options in the future, there are two basic mechanisms by which options can be repriced so that the exercise price of the option is reduced to be equal to the current trading price of the underlying shares. Each is described, in turn, below.

Option Exchange

The first is an option exchange whereby the underwater options are cancelled in consideration for the grant of new options with a reduced exercise price, equal to the FMV of the underlying securities on the date of the option exchange. To avoid any taxable disposition in the hands of the optionholder, such an option exchange must be structured under subsection 7(1.4), which, in the context of a repricing, requires the following:

- the optionholder must receive no consideration on the cancellation of the underwater options except for the new options; and

- the amount by which the value of the securities subject to the new options exceeds the exercise price payable under the new options (i.e., the "in-the-money" amount of the new options), determined immediately after the option exchange, must not exceed the "in-the-money" value of the cancelled options, determined immediately before the exchange.

In the context of a repricing to alleviate some of the hardship to optionholders resulting from a drop in value of securities due to an economic downturn, one would normally expect the Canada Revenue Agency to look to the trading price of the securities as a determinative indicator of FMV for the purposes of the foregoing.[3] Thus, where an option exchange is structured so that the underwater options (i.e., having no "in-the-money" value) are exchanged solely for new options with an exercise price equal to the FMV of the underlying securities at the time of the option exchange (i.e., also having no "in-the-money" value), both of the foregoing requirements should be satisfied. In such circumstances, the 50% deduction under paragraph 110(1)(*d*) should, to the extent that it was available in respect of the underwater options, be available pursuant to subparagraph 110(1)(*d*)(iii).

Straight Repricing

While a repricing can be accomplished by way of an option exchange, such an approach may raise adverse accounting issues, and an increased administrative burden associated with the cancellation and reissuance of options.[4] Accordingly, a straight repricing is often the desired approach, whereby existing option agreements are unilaterally amended to provide for the reduced exercise price. On the basis of the decision in *Amirault*,[5] such an amendment should not constitute a disposition of the option. The difficulty, prior to the introduction of proposed subsections 110(1.7) and 110(1.8), is that such an amendment would cause the loss of the deduction under paragraph 110(1)(*d*), since the exercise price of the option would be reduced to an amount below the FMV of the underlying security determined at the time that the option was originally granted.

In response to criticisms that this result was inappropriate from a policy perspective, the Department of Finance in 2002 introduced draft amendments to add subsections 110(1.7) and (1.8) to the Act, effective for taxation years after 1998. Notwithstanding their introduction eight years ago and the fact that they are to apply for all repricings after 1998, the proposals have languished in draft form until recently reintroduced.[6]

The impact of the proposed legislation is that the repricing is treated as an option exchange, such that, if the following conditions are satisfied, the 50% deduction under paragraph 110(1)(*d*) should, to the extent that it was available in respect of the original options, continue to be available:

- In the absence of the provisions, the optionholder would not have been entitled to the paragraph 110(1)(*d*) deduction if the options were exercised immediately after the repricing event.[7] This requirement should be satisfied in respect of any repricing that causes the exercise price of an underwater option to be reduced below the FMV of the underlying securities on the date the option was originally granted.

- If the repricing had been accomplished by way of option exchange pursuant to subsection 7(1.4), the paragraph 110(1)(*d*) deduction would be available.[8] As above, this requirement should be satisfied provided that the "new" exercise price is at least equal to the FMV of the underlying securities on the date of the repricing, such that, immediately after the repricing, the option continues to have no "in-the-money" value.

In relation to the previously introduced version of the proposed amendments, the Department of Finance has also confirmed that the provisions would apply to allow a repricing where the amendment in question both caused a reduction in the exercise price and an increase in the number of securities covered by the option, provided that the combined changes do not result in a net increase to the "in-the-money" value of the repriced option.[9]

Conclusion

The reintroduction of proposed subsections 110(1.7) and 100(1.8) will be welcome news to many employers considering option repricing. Assuming that the competing philosophical approaches lead a corporate employer to undertake a repricing strategy, the amendments will permit it to be done in an efficient manner without causing a loss of capital-gains like treatment to employee optionholders.

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[1] 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.

[2] *Income Tax Amendments, 2010.* The Bill had not yet been introduced at the time of writing and the draft legislative proposals are open for public comment to September 17, 2010.

[3] The situation may be different where a repricing is instituted to protect optionholders from a drop in value of securities due to the declaration and payment of a dividend or distribution. See, for example, *Income Tax Technical News No. 38* (September 22, 2008).

[4]From a public markets perspective, the TSX generally treats a straight repricing or an option exchange where the repriced options are granted within three months of the cancellation of the old options in the same manner. Repricing requires TSX approval in advance and may, in some circumstances, require shareholder approval.

[5]*Amirault v. MNR*, 90 DTC 1330 (T.C.C.), wherein the Tax Court confirmed that a simple reduction of the exercise price of an option is not so fundamental that it should be considered to go to the "root" of the contract and thus cause a disposition of the existing contract and entry into a new contract. See, also, CRA *Document* 9724275 (October 7, 1997), in which the CRA confirmed that it will apply the decision in *Amirault* such that a repricing of an option will not result in a disposition of that option.

[6]Subsection 59(2) of the *Income Tax Amendments Act, 2010.* The CRA indicated, in *Document* 2001-0105023 (January 8, 2002) and *Document* 2001-0096795 (March 6, 2002), that it would not reassess on the basis on current paragraph 110(1)(*d*) in the cases of straight repricing except in cases of abuse but that optionholders should contact their local Tax Services Office when claiming the paragraph 110(1)(*d*) deduction.

[7]Proposed paragraph 110(1.8)(*a*).

[8]Proposed paragraph 110(1.8)(*b*).

[9]Department of Finance comfort letter, dated May 29, 2002.

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