STOCK OPTIONS

Baird v. R.: Another Example of the Employee Stock Option "Capital Loss Trap"

Anu Nijhawan, *Bennett Jones LLP*

Background
Baird
Conclusion

The recent decision of the Tax Court of Canada in *Baird v. R.*[1] serves as a timely reminder of what has oft been referred to in the literature as the "capital loss trap" for employee stock options[2] -- a trap which, unfortunately, is far too easy to fall into in a volatile stock market.

Background

The trap is simply this. Upon the exercise of an employee stock option, pursuant to paragraph 7(1)(*a*), an employee has an income inclusion based on the value of the shares acquired less the exercise price paid. Where paragraphs 110(1)(*d*) or 110(1)(*d*.1) are applicable, the income inclusion is halved. While this 50% inclusion rate gives rise to a rate of taxation which is comparable to capital gains, it is important to realize that the benefit remains taxable as "income." If the shares acquired subsequently go down in value, the employee will, in most cases, have a capital loss – which capital loss cannot be used to offset the employment income inclusion. Advisors working in the area have often dealt with situations where a taxpayer has exercised options, crystallized the employment benefit,[3] and have then held the stock which plummets in value – leaving the employee in the unenviable tax position of having a tax bill on the employment benefit which cannot be offset by the resulting capital loss.[4]

Various legislative "fixes" have been discussed over the years. The one which has perhaps received the most traction is to allow the resulting capital loss to offset employment income up to the amount of the stock option benefit provided the acquired shares are disposed of within a specified period.[5] Pleas to the Department of Finance have generally fallen on deaf ears,[6] although a few remission orders have been granted alleviating the issue for a small group of taxpayers.[7]

The Department of Finance's refusal to introduce a legislative amendment is based on a view that employees who exercise stock options to acquire shares and decide to hold their shares are then acting *qua*investor and hence should be subject to the same tax regime as any other investor, including the risk that the shares will go down in value. With respect, this view is overly simplistic -- an optionholder who chooses to exercise an option and acquire a share of his or her employer is not in the same position as an investor who chooses to acquire a share with after-tax dollars. The differences are numerous, but the main ones that come to mind include the following. First, unlike an investor, an optionholder may be in a position of having to exercise an option before it expires, rather than being able to time his or her purchase. Second, an optionholder who acquires shares may be faced with hold period expectations by

their employer, unlike an investor that can choose the time of divestiture. Third, the shares in question may be thinly-traded or illiquid. Further, in many cases where a cashless exercise mechanism is not available, the only mechanism for an optionholder to realize value from his or her options is to exercise them. In that case, even where the employee sells the shares immediately, it is possible that the value of the shares will have declined below the value at the time the options were exercised.

In any event, absent a legislative amendment, taxpayers who find themselves in such a situation are faced with limited choices. Where the share acquired is of a small business corporation, the employee may be entitled to claim a "business investment loss," 1/2 of which will be deductible against any income source.[8] Where that is not the case, the employee may consider taking a tax filing position that the realized loss on the disposition of the shares is on income account. This is what was attempted by the taxpayer, unsuccessfully, in *Baird.*

Baird

The facts in *Baird*are fairly straightforward. Mr. Baird, a former employee of BCE Emergis, exercised employee stock options using borrowed cash and acquired the shares in 2000 at a time when they were worth between $7 and $10 million. In the years he continued to hold the stock, Mr. Baird spent the majority of his time assisting in his wife's athletic career while checking the stock market in the evenings. In 2001 and 2002, Mr. Baird sold his shares of BCE Emergis and claimed the resulting losses (exceeding $1 million) as non-capital losses from a business of trading in securities. The Minister rejected this position and the taxpayer appealed to the Tax Court.

Mr. Baird relied heavily on the recent decision in *Howard v. R.*,[9] in which the taxpayer convinced the Court that his losses on the disposition of shares acquired under option were losses from a business on the basis that he had specialized knowledge of the shares in question and of the market for them and that he devoted substantially all of his time to monitoring the performance of the shares as part of his employment duties. The Court distinguished *Howard*on the facts and went on to consider Mr. Baird's circumstances.

Notwithstanding the evidence that Mr. Baird had obtained a specialized trading account, subscribed to analysts reports, and took a Canadian Securities Institute course, the Tax Court dismissed Mr. Baird's appeal, holding that his activities of buying and selling shares did not constitute a business. Of note, the Court found as highly relevant to the analysis the following:

- Mr. Baird had treated his portfolio as capital in previous years;
- Mr. Baird did not report any home office expenses with respect to the alleged business;
- the majority of Mr. Baird's portfolio consisted of the BCE Emergis shares and there were very few actual trades;
- the options came about as a result of his employment and not because of any actions of Mr. Baird in the marketplace; and
- Mr. Baird did not act like a "trader" in that he continued to hold onto the shares even when they were decreasing in value.

The *Baird*case illustrates the difficulty that most individuals who hold shares acquired pursuant to the exercise of an option will have in taking the position that a subsequent loss is realized on income

account. Each of the factors listed above will generally be in place for most employee option holders who find themselves in the same position. Indeed, one would expect that a "typical" employee would not have the cash resources to hold a significant portfolio and would spend most of his or her time at other employment-related activities.

Conclusion

It remains to be seen whether future taxpayers, without the specialized knowledge of the shares evidenced in *Howard*, will be able to distinguish the *Baird*case to claim an income loss on a subsequent disposition of shares acquired pursuant to an option. It does appear, however, that the bar has been set fairly high. Thus, it would seem that the "capital loss trap" cannot easily be rectified, absent a legislative amendment. As such, to avoid a situation where an employee ends up with a tax bill on the option benefit which exceeds the ultimately realized value of the shares acquired, employee optionholders would be well advised to sell a sufficient number of the shares acquired as soon as possible after the option exercise to give them proceeds sufficient to pay the tax bill arising on the option exercise.

[1]2009 TCC 24.

[2] In this article, "employee stock option" is used to refer to a stock option which is governed by the provisions of section 7 of the Income Tax Act, 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] Even where the actual taxation is deferred automatically pursuant to subsection 7(1.1) (in the case of Canadian-controlled private corporations) or electively pursuant to subsection 7(8) (in the case of public corporations), the quantum of the benefit is nevertheless crystallized at the point the shares are acquired.

[4] The capital loss trap has been discussed in detail in other articles written in this publication. See, for example, Rhonda Rudick, "Finance Reviews Taxation of Stock Option Benefits Where Subsequent Decrease in Value" (2002) 13 *Taxation of Executive Compensation and Retirement*82 and Jamie Golombek, "Exercised Stocks Options and Subsequent Decline in Value – Finance Responds" (2003) 14 *Taxation of Executive Compensation and Retirement* 299.

[5] One example of this approach in Canada is seen in subsection 8(12), which applies to employee stock option trusts described in subsection 7(2) but which does not contain any time limitations.

[6] See the submissions to the Department of Finance of the CICA-CBA Joint Committee on Taxation, dated March 15, 2002 and the response in CRA *Document* 2003-0007795 (April 15, 2003).

[7]See, for example, Certain Former Employees of SDL Optics, Inc. Remission Order (P.C. 2007-1635 October 25, 2007) and Certain Former Employees of SDL Optics, Inc. Remission Order No. 2 (P.C. 2008-975 May 29, 2008).

[8] See definition of "business investment loss" in paragraph 39(1)(*c*). Half of a business investment loss is deductible as an allowable business investment loss against any income source, as provided by paragraphs 38(*c*) and 3(*d*).

[9]2008 TCC 51.

Published in *Taxation of Executive Compensation and Retirement*, (2009) vol. XX, number 8, page 1136

© Federated Press