Federated Press

STOCK OPTIONS

Henley v. R.: Welcome Guidance on Non-Section 7 Stock Options

Anu Nijhawan

Andrew Bateman, *Bennett Jones LLP*

Whereas section 7 of the Income Tax Act[1] provides a comprehensive regime for the taxation of stock options granted to employees to acquire securities of the grantor corporation or mutual fund trust, uncertainty continues to surround the tax implications of receiving stock options *qua*consultant or from a non-corporate employer. The limited jurisprudence[2] in the area is non-determinative, leading to increased uncertainty in the area, which issue has been the subject of various articles in this publication.[3] The recent decision of the Tax Court of Canada in *Henley v. R.*[4] provides further fodder for the analysis. The purpose of this article is to review this decision and to discuss its potential impact on the taxation of options in situations where section 7 of the Act is inapplicable.

Background

Where a stock option is granted in a situation where section 7 does not apply, the issues which will arise include:

- At what point in time should an income benefit first be assessed – at the time of the grant, when the options vest, upon exercise of the options, or at some other time?

- What is the quantum of the benefit? How is the option to be valued?[5]

Henley: the Facts

Henley involved a situation where the taxpayer's employer, an investment bank, received share warrants from a client as compensation for services. A portion of the warrants were allocated to the taxpayer, as consideration for the employment services rendered by him on that particular client's file. The warrants were exerciseable to acquire shares of the client corporation within two years for a price of $0.31 per share. At the time the warrants were issued, the trading price of the underlying shares was slightly higher, at $0.32 cents per share.

At some point after the taxpayer's employment with the investment bank had ceased, the warrants were exercised by the investment bank at the instruction of the taxpayer, and the shares immediately sold, for a total gain of $967,480. The investment bank included the entirety of this amount as income from employment on the taxpayer's T4 information slip issued in the year the warrants were exercised. The taxpayer took the position that the benefit under the warrants should be included in income from employment in the year the warrants were allocated to him and that any benefit over and above that amount ought to be treated as a capital gain.

Relying on the decision of the Federal Court of Appeal in *R. v. Robertson*, which held that the benefit at the time of the grant of non-section 7 options to an employee was not a "quantifiable" amount but that the entirety of the benefit should be included as employment income in the year of exercise,[6] the Minister of National Revenue argued that the entirety of the amount should be included as employment income in the year the warrants were exercised.

The *Robertson* decision notwithstanding, the Tax Court held in favour of the taxpayer, concluding that the taxpayer had received an employment benefit at the time the warrants were allocated to him, equal to the "in-the-money" value of the warrants on that date and that the gain above that amount should be taxed as a capital gain.

Future Implications

One of the most interesting aspects of the decision is the skillful basis on which the Tax Court distinguished *Robertson*, holding that it was decided on its facts and was inapplicable to the case at hand. While the Tax Court listed many reasons for distinguishing the two situations, the primary basis appears to have been that, in *Robertson,* the ability to exercise the options was tied to employment, whereas, in *Henley,* only the grant of the warrant was tied to employment. While the interpretation of the basis for this conclusion may vary amongst commentators, it is submitted that the distinction was based on the following factors, which may well dictate the result in other cases:

- *Vesting Tied to Employment*: In *Robertson,* the options were subject to a vesting period, during which the employment relationship had to continue, whereas the warrants in *Henley* were granted for past services and were not subject to vesting;

- *Relationship at Time of Exercise*: In *Robertson*, the options could only be exercised while the taxpayer was an employee (or shortly thereafter) while, in *Henley*, the warrants could be exercised even after the employment relationship had terminated, at which time the relationship between the former employer and the taxpayer was broker and client;

- *Property Subject to Option*: *Robertson* involved previously issued shares where the employer retained control of the shares, whereas the facts in *Henley* involved only share warrants. The grant of the warrants constituted an unconditional and irrevocable transfer of property, whereas the grant of the option was a "simple offer" that did not crystallize until the time it was exercised; and

- *Ability to Value*: As a matter of evidence, there was no ability to value the options in *Robertson*, whereas increased valuation technology made it possible in *Henley.* In coming to its conclusions, the Tax Court relied on paragraph 6(1)(*a*), which includes as employment income the value of any benefit in the year of receipt and that, in the circumstances before it, the warrants constituted a benefit at the time of grant because, at that time, the taxpayer had received an economic advantage.

In *Henley*, the "broken link" in the employment relationship appears to be a key factor in limiting the income inclusion to the value of the warrants at the date of grant. Accordingly, subject to a contrary view which might be taken by the Federal Court of Appeal, the case provides support for the argument that, where non-section 7 options are granted to a taxpayer and are explicitly stated to be granted in respect of past services and not subject to any vesting or other conditions to exercise, the taxpayer should only be subject to income treatment on the value of the option at the time of grant and could argue for capital treatment for any gain over and above that amount. This result is to be contrasted with the result under section 7, where a taxpayer will be subject to an income inclusion for the full amount of the benefit realized upon exercise (subject to the possibility of a paragraph 110(1)(*d*) deduction where the option is not in-the-money at the time of grant). Interestingly, however, it is consistent with the administrative position of the Canada Revenue Agency ("CRA") in relation to options granted to consultants.[7]

Another noteworthy aspect of the *Henley* decision is how the Tax Court chose to value the warrants at the time of grant. Based on its acceptance of the taxpayer's evidence, the Tax Court basically quantified the benefit received by reference to the "in-the-money" value of the warrant, pointing, in part, to the CRA's own recommendations for determining the value of options when granted to a shareholder as a shareholder benefit.[8] It is interesting that the Court did not consider other valuation methods – such as Black-Scholes, which would have taken into account the inherent value in an option, although one is left to wonder whether this was because no evidence of these types of method was adduced. It also remains an open question as to what type of evidence is acceptable for determining value, particularly for options "out of the money" or options where the exercise price is equal to the fair market value of the underlying property. In such cases, will the taxpayer be able to avoid any income inclusion and then claim a capital gain at the time the option is exercised?

Conclusion

Henley is currently the subject of a pending appeal to the Federal Court of Appeal. It will be interesting to see how that Court deals with its previous decision in *Robertson* and, in particular, with the distinction the Tax Court appears to draw between options granted for past services and those granted in respect of continuing services. From a policy perspective, the question also arises as to whether such a distinction is justifiable in light of the approach taken by the Department of Finance with respect to section 7 options. It may be time to seek a legislative solution.

---

[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] See, for example, *Robertson v. R.*,90 DTC 6070 (F.C.A.), *Del Grande v. R.*,93 DTC 133 (T.C.C.), *Abbott v. Philbin*, [1960] 2 All ER 763 (H.L.).

[3] See, for example, Ronit Florence, "Taxation of Stock Options Where Section 7 is Inapplicable – Robertson Revisited) 13 *Taxation of Executive Compensation and Retirement*79 and Anu Nijhawan and Tamara Larre, "Taxation of Stock Options Granted Qua Consultant" (2005) 16 *Taxation of Executive Compensation and Retirement* 496.

[4] *Henley v. R.*, 2006 DTC 3431 (T.C.C.), appeal to the Federal Court of Appeal is pending.

[5] For a review of valuation techniques for employee stock options, see Amin Mawani and Marsha L. Reid, "Comparability Issues and Employee Stock Options" (2005) 3 *Canadian Tax Journal* 607-639.

[6] In *Robertson*, the Federal Court of Appeal held that a grant of an option led to two economic benefits, both arising from employment, but that only the benefit arising at the time of exercise was quantifiable as that is the one realized by a flow of money or money's worth from the employer to the employee. That case involved the grant of options to an employee to acquire options to acquire shares of an oil company owned by his employer, an individual.

[7] See, for example, CRA *Document* 2000-0006395 (March 10, 2000).

[8] *Interpretation Bulletin* IT-96R6, "Options Granted by Corporations to Acquire Shares, Bonds, or Debentures and by Trusts to Acquire Trust Units" (October 23, 1996).

Published in *Taxation of Executive Compensation and Retirement*, (2007) vol. XVIII, number 6, page 785