Federated Press

STOCK OPTIONS

Taxation of Stock Options Granted Qua Consultant

Anu Nijhawan

Tamara Larre, *Bennett Jones LLP*

The competing demands of profitability expectations and higher workloads have increasingly led corporations to hire individuals on a contract basis rather than as employees. This practice has, in turn, led to issues concerning whether such independent contractors should be entitled to participate in the corporation's "employee-related" incentive plans, particularly with respect to stock options. The issue of the tax implications, pursuant to the provisions of the Income Tax Act,[1] of stock options granted to consultants has been the subject to various articles in this publication,[2] each of which has provided a critical overview of some of the tax issues which arise. The purpose of this article is to provide an overview of the most recent reiteration of the position of the Canada Revenue Agency (the "CRA")[3] on these issues, along with some alternative positions that could be considered.

By way of background, while section 7 provides for a comprehensive scheme for the taxation of employee stock options, subsection 7(5) is clear that the provision does not apply "... if the benefit conferred by the agreement [granting the stock option] was not received in respect of, in the course of, or by virtue of, the employment [of the taxpayer receiving the stock option]." As such, it is clear that non-employee consultants who are granted stock options should not be subject to the section 7 regime.[4] Consequently, the tax implications of a consultant receiving and exercising stock options must be determined by reference to the general provisions contained in the Act.

Grant of Stock Option

Where a stock option is issued to a consultant as payment for services rendered or to be rendered, it is generally accepted by practitioners and the CRA that the fair market value ("FMV") of the option should be included in the consultant's income pursuant to subsection 9(1) as being "profit from [the consulting] business" of the individual consultant.[5] It would follow that a corresponding amount could then be deducted by the granting corporation[6] as payment for services rendered.[7]

Although the principle is evident, the continuing issue is how one is to determine the FMV of the option at the time of its grant. At an economic level, it would seem that, because an option comes with valuable rights to acquire shares at a specified price, the option always has some value, even if it is difficult to quantify. However, an argument can also be made that, where the exercise price under the option is equal to the FMV of the underlying shares which could be acquired, the value of the option is, at the

time of grant, zero.

The CRA has offered the following guidance relating to the determination of the FMV of an option:

> [T]he fair market value of an option is the greater of:
>
> * the trading value of the rights received; and
>
> * the amount by which the fair market value of the shares subject to the option at the time of the option's distribution exceeds the exercise price provided in the option.[8]

In the situation where there is no trading market for the options and the exercise price for the underlying shares subject to the option is equal to their FMV at the time of the grant of the option, the CRA has appeared to accept that the option has no value and hence, no amount is required to be included in the income of the consultant.[9] Although not considered by the CRA in that situation, the corollary of this result would appear to be that the granting corporation would not be entitled to deduct any amount from its income at the time of the option grant.

The foregoing illustrates one of the uncertainties in the stock option arena. While the CRA's approach under such facts provides a favorable result for the consultant, the corporation is apparently denied a deduction. Where an immediate deduction is sought by the granting corporation, an alternative approach to that taken by the CRA might be to treat the arrangement between the consultant and the corporation as a barter transaction whereby the consultant bartered his or her consulting services in part for the option.[10] While the CRA has not, to the writers' knowledge, commented on the application of the barter model to stock options, the CRA has indicated that such model is applicable in a situation where shares are issued as consideration for consulting services.[11] In the absence of any provisions in the Act which deal with barter transactions, the CRA's administrative position is that the amount to be brought into income by a taxpayer providing services (here, the consultant) in a barter transaction is the amount the taxpayer "would normally have charged a stranger for his services" (i.e., the value of the services given up).[12] Under such an approach, the CRA goes on to suggest that the value of the consideration received "in kind" (in this case, the option) should only be considered when the value of the services given up cannot readily be valued. It could therefore be argued that, at the time the consultant receives the option, he or she should include in his or her income an amount in respect of the option equal to the value of the services provided, less any monetary consideration received for the services. This amount should correspondingly establish the consultant's cost of the option and the quantum of the granting corporation's deduction. Under such an approach, the actual value of the option would appear to be irrelevant.

Exercise of Stock Option

The CRA's historical administrative position has been that, where an amount is included in the consultant's income at the time of the grant of the option:

> Additional income or losses may also result from a subsequent exercise or non-exercise of the option. However, the effect of these will depend on whether the option is held in the business as capital property ... or is held as non-capital property used in a business.[13]

More recently, the CRA has clarified its view that the consultant will realize a gain equal to the amount by which the FMV of the shares on the date of exercise exceeds the option price, the price paid to acquire the option, and the amount included in income on the date the option was granted.[14] As to the nature of this gain, the CRA has historically taken the position that the gain will generally be on capital

account and subject to the rules in section 49.[15] However, more recently, the CRA has stated as follows:

> Whether this gain constitutes business income or a capital gain is a question of fact that cannot be resolved until the facts of a particular situation have been completely analyzed.
>
> If the facts show that the gain constitutes a portion of the consideration the consultant received for his or her services, the CRA feels that the gain must be treated as business income for the purposes of the ITA.[16]

The CRA's position appears to suggest that the option may remain an "income" investment until it is exercised.[17] An examination of the CRA's historical position on this point indicates that it may take this "income" view where the facts indicate that the option is exercised as a result of the consulting services.[18] This would appear to be the case where the facts indicate that the options granted to the consultant are in consideration not only for past services rendered but also for services that are to be rendered by the consultant over a period of time after the date of the grant.[19] In such circumstances, the CRA has previously stated that a portion of the gain on exercise should be viewed as consideration received for the services rendered and thus should be includible in income.[20] It is not, however, clear how such "portion" should be computed; clearly, the consultant will wish to structure arrangements so as to minimize any inference that the gain on the exercise of the option is on income account. The question of whether the granting corporation is entitled to any deduction is also open to question in such circumstances.

Conclusion

As is evident from the foregoing, there remains significant uncertainty regarding the tax consequences of stock option arrangements with consultants. From the granting corporation's perspective, a key issue will be to ensure an immediate deduction for the "value" of the option when granted as consideration for services rendered. From the consultant's perspective, the issues will be reducing the amount to be included in income at the time of grant of the option and ensuring that any subsequent gain arising on the exercise of the option is seen to be on capital account and not on income account. The lack of judicial consideration of the appropriate tax treatment of stock options received by a consultant, in addition to some weaknesses in the CRA's position, should permit a taxpayer to advance a position contrary to that of the CRA where such a position would be helpful.

[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, Ronit Florence, "Taxation of Stock Options Where Section 7 is Inapplicable – Robertson Revisited" (February 2002) 13 *Taxation of Executive Compensation and Retirement*79.

[3]This position was most recently reiterated in CRA *Document* 2004-0087041C6 (January 26, 2005).

[4]Before undertaking this analysis in practice, it is necessary to ensure that the individual has indeed been granted the stock options in his or her capacity as a consultant, and not as an employee. The characterization of an individual providing services as either an employee or an independent contractor has been the subject of various case law, most notably *Wiebe Door Service Ltd.*, 87 DTC 5025 (FCA) and *671122 Ontario Ltd. v. Sagaz*, [2001] 2 SCR 983. This article proceeds on the basis that it has been determined that the stock options are granted to an individual on the basis of his or her past or future consulting duties.

[5]CRA *Document* 2000-0006395 (March 10, 2000). See also CRA *Document* 9902145 (November 16, 1999), *Document* 1999-0013915 (May 3, 2000), *Document* 2000-0006935 (March 10, 2000), *Document* 2002-0151247 (July 15, 2002), *Document* 2003-0054581E5 (May 14, 2004), and *Document* 2004-0087041C6 (January 26, 2005).

[6]In this respect, paragraph 7(3)(*b*) would not appear to deny the deduction as no shares will be issued to an employee under the arrangement.

[7]On the basis that the stock options are granted in the course of business activities, and not on a capital basis, the rules in paragraph 49(1)(*b*) do not appear to be applicable on the grant of an option insofar as determining the quantum of the corporation's deduction.

[8]CRA *Document* 2002-0151247 (July 15, 2002). See also *Interpretation Bulletin*IT-96R6, paragraph 3 (October 23, 1996) and CRA *Document* 1999-0013915 (May 3, 2000).

[9]CRA *Document* 2000-0006395 (March 10, 2000).

[10]This argument was advanced by Stan Ebel and Curtis Stewart in "Update on Employee Stock Options and Employee Benefits," 2002 Canadian Tax Foundation Report (Toronto: Canadian Tax Foundation, 2003), 27:1-47.

[11]CRA *Document* 9624505 (October 11, 1996).

[12]*Interpretation Bulletin* IT-490, paragraph 8 (July 5, 1982).

[13]CRA *Document* 2000-0006935 (March 10, 2000).

[14]CRA *Document* 2004-0087041C6 (January 26, 2005). Subsection 248(28) should ensure that the FMV of the option, if any, previously included in income should be deducted from the amount to be included in income on the exercise of the option.

[15] CRA *Document* 2000-0032675 (September 22, 2000).

[16] CRA *Document* 2004-0087041C6 (January 26, 2005).

[17] In her article, at supra note 2, Ronit Florence argues that this is contrary to the decision of the Federal Court of Appeal in *Pollock v. R.*, [1994] 1 CTC 3.

[18] CRA *Document* 1999-0013915 (May 3, 2000) and *Document* 2003-0054581E5 (May 14, 2004).

[19] This could be the case where, for example, the option vests over time only as more consulting services are performed.

[20]CRA *Document* 2002-0151247 (July 15, 2002).

Published in *Taxation of Executive Compensation and Retirement*, (2005) vol. XVI, number 5, page 496