2008 CR p.15:1 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

TOPICAL ISSUES IN EQUITY-BASED EMPLOYEE COMPENSATION

Anu Nijhawan and Steven Sieker

2008 CR p.15:1 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Abstract

This paper is a compilation of various issues that have arisen in the area of equity-based employee compensation in the last few years. In an economic downturn, there is an increasing emphasis on performance-based vesting and on repricing strategies, both of which the authors discuss. Issues arising in the context of corporate mergers and acquisitions and conversions of mutual fund trusts into corporations are also discussed.

Keywords Executive compensation; employee stock options; phantom shares; rollovers; acquisitions and mergers.

2008 CR p.15:1-2 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Introduction

Recent surveys of Canadian publicly traded corporations and mutual fund trusts (MFTs) indicate that virtually all such entities utilize one or more types of equity-based employee compensation programs.[1] Even in an economic downturn, experts predict a continued focus on long-term incentive programs, particularly for executive compensation, with a renewed interest in stock options and other performance-based equity awards. While such programs, once implemented, generally operate without ongoing tax advice, numerous issues and planning opportunities pursuant to the provisions of the Income Tax Act and the regulations thereto[2] can arise in their establishment and in the midst of restructuring transactions. The focus of this paper[3] is on some of these recent issues.[4]

When the topic of equity-based compensation arises, one traditionally thinks of stock options. This is perhaps not surprising, given the prevalence of stock | options and the preferential tax regime that governs them.[5] Today, however, equity-based awards generally fall within one of two broad categories.[6] The first is stock or trust unit option plans (including tandem stock/unit appreciation rights, generally referred to in this article as "options"). The second is phantom unit plans, which include restricted stock units or restricted trust units (RSUs and RTUs),[7] deferred share units (DSUs),[8] and share appreciation rights and trust unit appreciation rights (SARs and TARs).[9] A discussion of the particulars of the tax regime governing each of the foregoing plans[10] is beyond the scope of this paper; we have assumed that readers will have a general understanding of the applicable rules.

2008 CR p.15:2-3 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Performance-Based Vesting

Employee stock options were originally intended to align employee interests with shareholder interests, rewarding employees for growing the value of the employer company as represented by an increase in the share price. Over time, however, various criticisms of options were offered, including the criticism that options did not reward value creation as much as they rewarded a rising stock market.

As a result, there has been a gradual but perceptible shift toward the introduction of performance criteria as a prerequisite to the vesting of options. The general concept is that an employee is granted a number of options that will vest or become exercisable only if particular criteria are met. For example, an employee might be awarded options to a maximum of 10,000 shares, with the number of actual options available for exercise in the future to be based on a formula that takes into account growth in sales or market share. The important point for the purposes of the following discussion is that the employee does not know for certain at the time of the original grant how many options will ultimately be exercisable. Although these types of performance-based options may raise a number of legal and tax issues, the question that we will consider is whether the provision that gives capital-gains-type treatment to employee stock options applies in circumstances where the vesting of an option is dependent on performance conditions.

Paragraph 110(1)(d) " " permits a deduction from net income equal to half the amount of the benefit deemed to have been realized under section 7 " " when various conditions are satisfied. The relevant condition for this discussion is the requirement that the amount payable by the option holder to acquire the shares under the option must not be less than the fair market value (FMV) of the shares at the time that the "agreement was made."[11]

The question is whether, for the purposes of paragraph 110(1)(d) " ", an agreement is made at the time an employee is granted options subject to the performance criteria, or whether the agreement does not come into being until the performance criteria are satisfied. If the former is true, and assuming that the exercise price is equal to the FMV of the underlying share at that date, the requirements for the paragraph 110(1)(d) deduction should be satisfied. If the latter is true, the | FMV requirement of clause 110(1)(d)(ii)(A) " " will often not be satisfied, since at the time that the performance criteria are satisfied the market value of the share underlying any particular option would reasonably be expected to be an amount other than the exercise price under the option agreement because that price would have been set much earlier. If clause 110(1)(d)(ii)(A) does not apply, the impact is a full income inclusion in the employee's income, since the 50 percent deduction provided by that paragraph will not be available.

2008 CR p.15:3-4 Equity-Based Employee Compensation (Nijhawan, A. & S. Sicker)

Canada Revenue Agency Commentary

Until somewhat recently, the CRA's views on when an agreement is made for the purposes of paragraph 110(1)(d) " " in the context of performance-based vesting was unclear, although a number of statements of relevance had been made over the years. In 1987, the CRA, responding to a question on the meaning of the expression "at the time the agreement was made" for the purposes of the paragraph 110(1)(d) deduction, stated that the expression refers to "the date on which the option to acquire a specific number of shares at a specific price is granted to the employee by the employer."[12] In 1988,[13] the CRA commented specifically on the effect of a "condition" to the issuance of shares under an option that had been granted. In that situation, a corporation wished to issue options to employees under a stock option plan that had been approved by the directors but not yet by the shareholders. Under the relevant stock exchange rules, the corporation was permitted to issue options in those circumstances, provided that no shares were actually issued under the options until shareholder approval was obtained. In this context, the CRA provided the following non-binding opinion:

> It is our view that the expression ". . . at the time the agreement was made," as contained in subparagraph 110(1)(d)(iii) of the Act, *refers to the date on which the corporation unilaterally undertakes to sell or issue the shares of its capital stock.* We would, therefore, agree that, in your hypothetical situation, provided the approval by the shareholders was not a condition precedent to the issuance of the stock options, the time the agreement was made would be the time at which the option is granted by the directors of the Company. If, however, the Company was legally prohibited from issuing shares under the [stock option plan] until it was approved by the shareholders, we would not consider the agreement to have been made until that approval was obtained.[14]

The foregoing extract indicates the CRA's view that the "agreement" for the purposes of the paragraph 110(1)(d) ¨ ¨ deduction is considered to be made at the date on which the corporation undertakes to sell or issue shares, so long as the corporation is legally permitted to issue shares at that time.

A direct consideration of performance-based vesting came on May 29, 2007,[15] when the CRA responded to a situation involving a Canadian-controlled private corporation that had implemented an employee stock option plan under which the board of directors could grant options to employees to acquire common | shares in the corporation at an exercise price determined at the date of grant. A percentage of the options granted would expire each year, and all of them would expire five years after they were granted. Each year, a compensation committee would determine for each employee the number of options that he or she could exercise and would confirm this decision by sending a notice with the information to each employee. The CRA was asked at what time, for the purposes of paragraph 110(1)(d) ¨ ¨, the employer would have agreed to issue shares to an employee in this situation.

The CRA stated that the company would be considered to have agreed to issue the common shares to the employee at the time the notice was sent by the company to the employee, since it was only at that time that the company unilaterally agreed to issue those shares to the employees. In the CRA's view, prior to the employee receiving notice of the number of exercisable options, the company had no obligation to issue shares and the employees had no rights to purchase shares. As a result, in order to qualify for the one-half deduction pursuant to paragraph 110(1)(d) " ", the amount paid by the employees for shares could not be less than the FMV of the shares at the time that the notice was mailed.

Is the CRA Correct?

A broad interpretation of the CRA's opinion could mean that any performance-based vesting scheme for options would not allow the employee to qualify for paragraph 110(1)(d) " " treatment. But is the CRA's view as expressed in 2007 correct as a matter of law, and does it apply to the normal public company situations? The starting point for answering this question is to note that neither "agreed" nor "agreement" is defined in the Act. As a result, to determine the meaning of "agreement" for the purposes of the Act, we are forced to consider the meaning of the term at common law. *Black's Law Dictionary* defines "agreement" in the following terms:[16]

> *agreement* . . . 1. A mutual understanding between two or more persons about their relative rights and duties regarding past or future performances; a manifestation of mutual assent by two or more persons. . . . 2. The parties' actual bargain as found in their language or by implication from other circumstances, including course of dealing, usage of trade, and course of performance. . . .
>
> The term "agreement," although frequently used as synonymous with the word "contract," is really an expression of greater breadth of meaning and less technicality. In its colloquial sense, the term "agreement" would include any arrangement between two or more persons intended to affect their relations (whether legal or otherwise) to each other.[17]

These definitions suggest that the term "agreement" is generally synonymous with the term "contract," which means a legally binding agreement, but is also a | term of broader application, including a mere understanding between parties meant to affect their relationship which might fall short of an actual contract. It is interesting to note that Parliament did not use the phrase "agreement in writing" in paragraph 110(1)(d) " ", or other more formal terminology such as "contract" or "binding agreement." This may indicate an intention to take a less restrictive view of when an agreement is made, but it may also indicate that it was assumed that "agreement" would be interpreted in this context as an agreement enforceable at law.

Guidance as to the appropriate meanings to be ascribed to the terms "agreed" and "agreement" in the tax context can also be found from a review of jurisprudence considering the issue. A broad interpretation of the terms "agreed" and "agreement" is supported by other decisions dealing with issues arising under the provisions of section 7. For example, in *Mansfield v. The Queen*,[18] the court held that the conversion of a convertible debenture by an employee in respect of the employer's shares was governed by section 7, on the basis that "agree" and "agreement" are not terms of art or technical expressions. A similar conclusion was reached in *Aylward et al. v. The Queen*,[19] in which the issue was whether a former employee could benefit from the stock option rules in section 7 if he was no longer an employee at the time the stock option was granted. In finding that the stock options were nevertheless governed by section 7 because they were granted by virtue of the employment relationship, the Tax Court stated as follows with respect to the application of section 7:

> The phrase used in subsection 7(1) is:
>
> (1) Subject to subsection (1.1), where a corporation has agreed to sell or issue shares of the capital stock of the corporation—
>
> There is no further definition of the term "agreed." *There is nothing to suggest that what is required is a formal contract in the sense of an offer and acceptance*. . . .
>
> In *Mansfield v. The Queen*, *supra*, it was held that in section 7 of the *Act*,"'agree' and 'agreement' are not terms of art or technical expressions."
>
> As argued by counsel for the Appellant, the Court finds that the agreement in question "need not be a detailed contractual obligation." The case of *Amirault v. MNR*, *supra*, appears to support this view.[20]

2008 CR p.15:5/6 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

The foregoing broad interpretation was endorsed in *McAnulty v. The Queen*, with respect to paragraph 110(1)(d) " ":

> The words "agree" or "agreement" generally connote to a lawyer a binding contractual commitment and it is in this sense that the respondent argues that the word must be interpreted in paragraph 110(1)(d). This is certainly the conventional meaning. . . .
>
> The law is clear that such an agreement need not be in writing. If Parliament requires an agreement to be in writing it is quite capable of saying so as it has in many sections of the *Income Tax Act*. . . . |
>
> Counsel for the appellant went further and submitted that *"agreement" in section* 7 " " and paragraph 110(1)(d) " " could mean a non-binding commitment by a corporation to sell shares to an employee at a fixed price. *The point is not without merit*, when one considers the way in which employee stock options are granted to employees. The company traditionally allocates stock options to employees based on a variety of criteria such as position in the company, seniority or past services. How many options are issued to a particular employee is a matter of management's discretion, not of negotiation and bargaining between the employee and the company. *Whether at the time of allocation a binding agreement comes into existence may be an open question—I think that it does—but it is certainly at that point that it can be said that the company "agreed" to sell shares to the employee*. . . .
>
> My view is simply this: *a broader approach to the interpretation of "agree" and "agreement" in paragraph 110(1)(d) is required if the object of that paragraph is to be achieved*. A technical one that excludes an oral commitment made by a senior officer of the company with apparent authority would in my view destroy the purpose for which the provision is in the act, that of according to the taxation of employee stock options what

essentially amounts to capital gains treatment where the option price at the time of the agreement is no less than the price at which the shares are trading at that time.[21]

Although *McAnulty* dealt specifically with an oral representation by a senior executive, it indicates a preference for a "broad" interpretive approach as opposed to a "technical" approach in relation to the stock option rules and that, at the very least, an "agreement" exists for the purposes of paragraph 110(1)(d) " " at the time that options are "allocated" to employees, notwithstanding that there may be, at that time, something less than a "binding agreement."

2008 CR p.15:6-7 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Toward a Grand Unifying Theory

Why is the question of whether an agreement must be a legally binding agreement, as opposed to simply an agreement, relevant? Can the CRA's statements be reconciled with the jurisprudence?

In simple terms, an agreement is nothing more than a mutual arrangement between two persons to affect their relationship. To achieve an agreement requires only a common understanding or, in legal terms, consensus ad idem. To paraphrase G.H.L. Fridman,[22] agreement is the basis of any legally enforceable contract, which is to say that there must be a substratum of agreement or consensus ad idem. In the context of performance-contingent vesting, it will invariably be the case that the parties have achieved a minimum substratum of agreement. The employer will have offered to grant options to the employee, subject to whatever performance terms may be stipulated, and the employee will, by word, deed, or implication, have accepted such terms. Therefore, if a legally binding agreement or contract is not required for the application of paragraph 110(1)(d) " ", then it | will almost invariably be the case that the parties will have reached an agreement in the broadest sense of the term, meaning that the paragraph 110(1)(d) treatment should be available.

If this interpretation is correct, then the CRA's view may be incorrect, or the CRA may be reconciled to the jurisprudence on the basis that it is indicating (albeit not explicitly) that an agreement will be reached between the parties only at the time at which the employer has agreed to issue a specific number of shares at a specific price, because it is only at that time that there is actually consensus ad idem. In the context of a situation where the vesting of options is entirely at the discretion of the employer, it is arguable that in fact nothing was agreed between the parties. Instead, there was a mere promise by the employer to consider vesting options, and the complete lack of certainty or control by the employee over the ultimate vesting may therefore mean that there is no agreement. As a matter of employment law this may or may not be correct, since the conduct of the parties toward one another could lead to an argument that the employee had a reasonable expectation to receive some options; but it is fair to say that a mere promise by an employer to grant options entirely at the employer's discretion could lead to a conclusion that no agreement was truly reached. By contrast, a contract with objective performance criteria moves beyond a mere promise, since the employer is bound to vest the options if the criteria are met and the employee could seek to enforce this obligation, in contrast to a situation where the vesting of options was entirely discretionary. In the context of objective performance criteria, it would be much more difficult to argue that the parties had not reached consensus ad idem.

However, if the "agreement" required by paragraph 110(1)(d) " " is a legally binding agreement, or contract, the legal analysis becomes considerably more complex. Indeed, a discussion of all the requirements for a legally binding agreement fills many texts on contract and is therefore clearly outside the scope of this paper.

That being said, an issue that arises in this context is whether or not the performance conditions are conditions precedent or, in the uniquely Canadian sense, "true" conditions precedent that prevent the formation of a contract. One author has raised the question of whether, where vesting of a stock option is subject to conditions relating to the employer corporation's share price or performance relative to other businesses, including "total shareholder return" conditions, the option agreement, for the purposes of paragraph 110(1)(d) " ", may come into being only when such conditions are satisfied, but not before the time when the options were originally granted.[23]

2008 CR p.15:7/8 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

To make sense of this issue, it is necessary to briefly understand that the law in Canada as it relates to conditions is apparently unique[24] in that there are not only "ordinary" conditions precedent or subsequent, but "true" conditions precedent. The distinction may be explained as follows:

> If a condition is a true condition precedent, there is no contract until it is satisfied. If a condition is the other sort of condition, then, in the event of its non-fulfillment, there may still be a binding contract between the parties, | depending on the way in which the innocent party, guiltless of any breach, reacts to a breach of the condition. It follows from *Turney v. Zhilka*, therefore, that in Canada, a distinction now exists between a condition relating to the *existence* of any contractual obligation and a condition that is precedent to *performance* of a contractual obligation by the other party, not the one subject to fulfillment of the condition precedent.[25]

Applying this conceptual structure to performance-based options, the critical question must therefore be whether a condition is a true condition or an ordinary condition; if it is the former, the contract does not come into existence until the condition is met. By contrast, with an ordinary condition there is still a contract, but the enforceability of a particular obligation may (or may not, depending on the reaction of the other party) be suspended.

As indicated by the above quotation, the leading case on the issue of contractual conditions is *Turney et al. v. Zhilka*, in which the Supreme Court of Canada distinguished between ordinary conditions precedent (which merely suspend the performance of an obligation) and true conditions precedent (which suspend the creation of an obligation):

> The obligations under the contract, on both sides, depend upon a future uncertain event, the happening of which depends entirely on the will of a third party—the Village council. *This is a true condition precedent—an external condition upon which the existence of the obligation depends*. Until the event occurs there is no right to performance on either side. The parties have not promised that it will occur. In the absence of such a promise there

can be no breach of contract until the event does occur.[26]

The determination of whether or not a condition constitutes a true condition precedent is a fact-sensitive determination and one for which there is no unequivocal test. It is not clear from *Zhilka* what the critical indicator is, except that it is an event that is "entirely" dependent on the will of a third party.

We are not aware of any jurisprudence that has considered this issue in the context of stock options. However, the question of whether a condition constitutes a true condition precedent has arisen in the tax context in cases where the issue has been the timing of a disposition and/or whether certain amounts were "receivable." The most significant of these cases is *The Queen v. Imperial General Properties Limited*,[27] which provides an indication that a primary factor in determining whether or not a condition is a true condition precedent is the degree of control of the parties over the condition.

In *Imperial General Properties*, the Federal Court of Appeal indicated that the parties' intentions with respect to the existence of the condition were not relevant. On different facts, however, the same court, in *Greenway v. The Queen*,[28] suggested that the critical factor was whether the parties intended that the various agreements should be effective forthwith or whether the intention was that non-fulfillment of the conditions would result in a nullity of the agreement.[29] |

In the context of performance-based vesting, it is therefore important that the option agreement itself provide evidence that the employer intends that the "agreement" be made as of the date the agreement is signed or given to the employee, and for the performance criteria to go only to vesting and not to the question of whether the agreement exists. Once an option agreement is entered into, it should also be made clear that the employer is unable to withdraw from its obligations if the performance criteria are satisfied.

The employer, in compliance with Toronto Stock Exchange (TSX) rules and securities laws, will also be required to report the grant of performance options on a monthly basis and in its annual information circular, providing further evidence of an intention to be legally bound and a course of conduct indicating that the employer considers itself to be bound by the grant of such performance options. Similarly, employees who are granted options will clearly believe that such options are part of their annual compensation package for the year of the grant. Certainly it would come as a surprise to most employees to hear that they did not have a binding agreement with their employer, and in the event of litigation the CRA would have the unenviable task of convincing a court that notwithstanding that both parties to the contract thought they had an agreement, and acted as though they had an agreement, they nonetheless did not have an agreement. Thus, at some level, the agreement must have been made at the date the option is granted, even if it is subject to vesting criteria.

A further point to note is that a true condition precedent is entirely reliant on the will of a third party. Since performance-based options should, if properly designed, encourage performance by the employee, it should also be the case that the employee has some control over the performance condition, even if incremental. Therefore, a performance condition that refers to market share or improved efficiency or some other metric that can be influenced by employee behaviour should not be considered to be entirely reliant on the will of a third party, since success or failure under such a formula should, if only to some small degree, be influenced by the individual employee or the employee acting collectively with other employees.

Another factor that may be relevant is the employer's ability to waive the requirement that the performance criteria be satisfied prior to the vesting of any performance options. The cases are divided on the issue of whether the presence of a waiver means that a condition is not a true condition precedent, but there is some jurisprudence to support this position. For example, in *Imperial General Properties*, the court held that the presence of an express waiver makes no difference to the determination of whether a true condition precedent exists.[30] Other cases, however, have held that the presence of an express right of waiver is an indication that a condition is not a true condition precedent,[31] particularly where the non-satisfaction of the condition does not make it impossible to perform the obligations under the agreement.

2008 CR p.15:9/10 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

In summary, performance-based vesting raises serious issues for employers and employees alike. Performance criteria that are completely at the discretion | of the employer or that are completely unrelated to the employee's performance may trigger concerns that paragraph 110(1)(d) " " treatment is not available to the employee. In the context of entirely discretionary option awards, the question is whether there is really an agreement between the parties. In the context of performance criteria completely dependent on the will of a third party, a different issue arises—namely, that the condition is a true condition precedent such that the agreement does not come into existence until the condition is satisfied.

In between these two extremes is the sensible middle ground in which paragraph 110(1)(d) " " should apply. Since the intention behind performance-based vesting is to encourage performance by employees, criteria that are objectively tied to employee performance should qualify for paragraph 110(1)(d) treatment. On the one hand, the use of objective criteria, such as cost reduction or improved efficiency or market share, removes the argument that the employer is making a mere promise that is unenforceable. Instead, the employee has a contract with terms that may allow him or her to seek a legal remedy if the criteria are met. In these circumstances, there is certainly consensus ad idem, and probably a legally binding contract. On the other hand, the use of criteria that are somehow subject to influence by the employee removes the argument that there is a true condition precedent that prevents the agreement from coming into existence. Since a well-designed performance-based option agreement should encourage employee performance, having criteria like improved efficiency, improved market share, or cost reduction, all of which are to some degree within the control of the employee, should eliminate the argument that no agreement came into existence. Clear contractual terms indicating an intention by the parties to be bound by the agreement would also be supportive.

2008 CR p.15:10 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Corporate Mergers and Acquisitions

In any corporate merger or acquisition (or other significant corporate restructuring) where significant equity awards are at stake, numerous considerations will have to be addressed. What follows is a survey of some of the areas where caution is warranted.

2008 CR p.15:10/11 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Prescribed Share Issues Arising on the Exercise or Surrender of Stock Options[32]

The potential acquisition of a target corporation (Targetco) by another corporation (Acquireco) is often a reason for option holders to celebrate. In addition to the anticipated increase in the value of the Targetco shares (and hence the value of the Targetco options), option holders often benefit from accelerated vesting of the Targetco options as a consequence of the transaction. Holders of vested stock options (whether vested in the normal course or subject to accelerated vesting) will then be entitled to exercise their options and tender the Targetco shares so received to the bid by Acquireco or, alternatively, where provided for, to surrender | the options in exchange for a cash payment equal to the in-the-money amount. From a tax perspective, however, a critical issue affecting many Targetco option holders will be to ensure that option holders remain entitled to claim the 50 percent deduction permitted by paragraph 110(1)(d) " ". Aside from the requirement that the exercise price of the Targetco option be at least equal to the FMV of the underlying shares on the date that the option was granted, the Targetco shares must be qualified as "prescribed shares" at the time that the option is exercised or surrendered. That requirement can often raise surprising issues in the context of a corporate acquisition transaction, particularly as a consequence of provisions in a pre-acquisition agreement between Targetco and Acquireco.[33]

2008 CR p.15:11 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Regulation 6204 Generally

Regulation 6204 " " sets out the requirements that must be met for a share to constitute a "prescribed share" for the purposes of paragraph 110(1)(d) " ". Broadly speaking, a share is not a prescribed share if it has any of the characteristics of a preferred share or is convertible into any share having any such characteristics. In an ordinary public corporation stock option plan, this requirement is generally met by ensuring that the underlying shares subject to the options are garden-variety common shares. The structuring of a corporate acquisition may, however, affect the status of a share that was previously a prescribed share and cause it to cease to qualify. In the context of corporate acquisitions, the requirements in regulations 6204(1)(a)(i) " " and (iv) and 6204(1)(b) " ", described below, are particularly noteworthy.

2008 CR p.15:11-12 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Regulation 6204(1)(a)(i): Dividend Entitlement

Pursuant to regulation 6204(1)(a)(i) " ", under the terms and conditions of the share or "any agreement in respect of the share or its issue," the amount of the dividends that the corporation may declare or pay on the share cannot be limited to a maximum amount at that time or at any time thereafter ("the dividend entitlement requirement"). Pre-acquisition agreements commonly contain provisions that prohibit the board of directors of Targetco from declaring or paying any dividends in excess of a specified amount. The concern is whether such a prohibition constitutes a violation of the dividend entitlement requirement, which essentially turns on a determination of whether the pre-acquisition agreement is an "agreement in respect of the share."

The concern has recently regained some prominence because of a 2007 technical interpretation,[34] in which the CRA considered a situation where a corporation had made a covenant, pursuant to a loan agreement, that it would not pay dividends in excess of 50 percent of its net income. While the CRA acknowledged that the question was one of fact and referenced previous acceptances of this type of loan condition,[35] in those circumstances the CRA felt that the covenant would constitute a violation of the dividend entitlement requirement, notwithstanding | that neither the option holders nor the shareholders of the corporation were a party to the loan agreement. The CRA's position raises similar concerns with respect to covenants in pre-acquisition agreements. Arguably, a covenant in respect of dividends in a loan agreement is distinguishable from a similar covenant in a pre-acquisition agreement, since the former is intended to be long-lasting and goes directly to the operation of the corporation's business, while the latter is intended to be in effect only for a limited period and may not even be in effect at the time that the option is exercised or surrendered.[36] Nevertheless, any such distinction is fraught with uncertainty.

With due respect to the CRA's views, such a position, in addition to being commercially unrealistic, seems contrary to the object and spirit of the rules in question. In analyzing whether the pre-acquisition agreement (or loan agreement, for that matter) is an "agreement in respect of the share" for the purposes of regulation 6204(1)(a) " ", the subject phraseology must be interpreted textually, contextually, and purposively,[37] such that its meaning is determined in light of the underlying purposes of the prescribed share rules in particular and the stock option rules in general. A review of the original budget papers accompanying the introduction of the paragraph 110(1)(d) " " deduction indicates that the policy behind the prescribed share requirement is that the deduction should be available only where the employee option holder is granted the right to acquire true "equity" shares (that is, shares with respect to which there is no guarantee of an increase in value).[38] Thus, arguably, a covenant in respect of dividends should constitute an "agreement in respect of the share" for the purposes of regulation 6204(1)(a) only where such a covenant directly detracts from the nature of the subject share as a share that participates in the growth (or loss) of the corporation.

In fact, a pre-acquisition agreement does not affect the terms and conditions of the Targetco shares, and any prohibition on dividends is more properly a prohibition on a discretionary power of the directors of Targetco but does not alter the fundamental rights of a shareholder. This argument is supported by reference to section 24(3)(b) of the Canada Business Corporations Act[39] (and comparable provisions in the corporate legislation of each of the provinces), which provides that where a corporation has only one class of shares, the rights of the holders of the shares include the right to receive any dividend declared by the corporation. Thus, where Targetco has only one class of shares, it is clear that the holders of Targetco shares have an unlimited right to dividends, subject only to the discretion of the directors not to declare them.

2008 CR p.15:12/13 Equity-Based Employee Compensation (Nijhawan, A. & S. Sicker)

Having regard to the purpose of the prescribed share rules, a strong policy argument can also be made that the phrase "agreement in respect of the share" for the purposes of regulation 6204(1)(a) " " should include those agreements that affect the legal ability of the corporation to declare dividends, but not those that might make it factually difficult or unlikely for the corporation to declare dividends. A dividend covenant in a pre-acquisition agreement does not prevent the declaration and payment of dividends—such a payment would be a breach of | the pre-acquisition agreement, but the dividend would remain legally declared. In contrast, a dividend covenant in a unanimous shareholders' agreement would mean that a dividend would be ultra vires the corporation. In other contexts,[40] the courts have recognized the distinction between, on the one hand, contractually binding agreements outside the constating documents the breach of which creates rights in a third party and, on the other, legally binding provisions within the constating documents. Arguably, the former should not be considered "agreements in respect of the share," while the latter should.

It is these types of arguments that must be relied upon in the typical scenario, where commercial constraints require a pre-acquisition agreement to contain this type of prohibition; indeed, many takeover transactions continue to proceed on this basis. Nevertheless, given the CRA's position as illustrated in the technical interpretation described above, and the broad meaning that the courts have given to the phrase "in respect of" as implying any connection between two things,[41] it is difficult to be entirely certain that a pre-acquisition agreement does not constitute an agreement in respect of the share. Accordingly, where commercially feasible, it remains advisable to avoid the issue by replacing the prohibition on dividends in the pre-acquisition agreement with another mechanism to address the concern that Targetco may pay unexpected dividends—for example, a clause which provides that for every dividend declared of $1.00 per share, the offer price to be paid by Acquireco will be decreased by $1.25 per share.[42]

2008 CR p.15:13-14 Equity-Based Employee Compensation (Nijhawan, A. & S. Sicker)

Regulations 6204(1)(a)(iv) and 6204(1)(b): Acquisition by a Specified Person

Regulation 6204(1)(a)(iv) " " prevents a Targetco share from being a prescribed share where, under the terms and conditions of any agreement in respect of the share, the holder can cause a "specified person" in relation to Targetco to acquire the share. Similarly, regulation 6204(1)(b) " " prevents prescribed share status where there is a reasonable expectation that such a specified person will acquire the share within two years from the date of its issue.[43]

Where the terms and conditions of the Targetco options provide for the acceleration of vesting of those options so that they can be exercised and the Targetco shares so acquired tendered to the bid by Acquireco, it appears that there is a reasonable expectation that Acquireco will acquire those shares within the prohibited two-year period. Even where vested acceleration is not contemplated, the mere fact that an option is exercised or surrendered in the face of a takeover bid may lead to the same reasonable expectation. Thus, to ensure that the Targetco shares retain their prescribed share status, it is critical to ensure that Acquireco is not a "specified person" of Targetco within the meaning of regulations 6204(1)(a)(iv) and 6204(1)(b).

Regulation 6204(3) " " provides that for the purposes of regulation 6204(1) " ", a specified person in relation to a corporation includes |

> any person . . . with whom the corporation does not deal at arm's length otherwise than because of a right referred to in paragraph 251(5)(b) " " . . . that arises because as a result of an offer by the person . . . to acquire all or substantially all of the shares of . . . the corporation.

To the extent that a pre-acquisition agreement can be said to give Acquireco a future contingent right to acquire greater than 50 percent of the Targetco shares (for example, through lockup agreements), Acquireco and Targetco will then be considered to deal at non-arm's length pursuant to the interaction of paragraphs 251(5)(b) " ",[44] 251(2)(b), and 251(1)(a).[45] Thus, unless the transaction can fit within the exclusion for rights arising due to "an offer [by Acquireco] to acquire all or substantially all of the shares of [Targetco]," the mere entry into a pre-acquisition agreement could cause the Targetco shares to cease to be prescribed shares for the purposes of the paragraph 110(1)(d) " " deduction.

2008 CR p.15:14-15 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

While the policy behind the exception to the specified person definition in regulation 6204(3) " " appears to be to exclude all potential acquirors, the words of the provision do not appear to achieve this purpose. In particular, the exclusion will apply to ensure that Acquireco is not a specified person in relation to Targetco at the time that the Targetco options are exercised or surrendered only if

- the Targetco options are exercised or surrendered *before* Acquireco actually acquires control of Targetco (at which time Acquireco would be a specified person even in the absence of any paragraph 251(5)(b) " " rights), and
- Acquireco's rights to acquire Targetco shares arise from an "offer" to acquire "all or substantially all" of the Targetco shares.

The first requirement—that is, timing—should be manageable in most situations. For example, all options could be open for exercise or surrender only until the time that immediately precedes the acquisition of Targetco shares by Acquireco.[46] The second requirement raises several issues, some of which are discussed below.

The exception from Acquireco constituting a specified person in relation to Targetco is dependent upon an offer. From a policy perspective, one would think that "offer" is a broader term than a mere contractual offer and could be construed to encompass other situations where, through a transaction or series of transactions, Acquireco is acquiring Targetco shares. Clearly, Targetco option holders should not be subject to differing entitlements to the paragraph 110(1)(d) " " deduction depending on the form of transaction through which Acquireco and Targetco are combined. Nevertheless, the use of the term "offer" raises questions—not all takeovers and corporate acquisitions take the form of an offer by Acquireco.[47] For example, Acquireco could be combined with Targetco through a court-approved plan of arrangement, or Targetco could be acquired through a triangular amalgamation of Targetco and a wholly owned subsidiary of Acquireco pursuant to subsection 87(9). The CRA has recently provided an affirmative ruling stating that pursuant to the exception in regulation 6204(3)(a) " ", the Acquireco | pursuant to a plan of arrangement would not be a specified person in relation to Targetco.[48] The question in relation to a triangular amalgamation remains open.[49]

In addition, the exclusion from specified person status in regulation 6204(3) " " applies only where the offer by Acquireco is one to acquire "all or substantially all" of the Targetco shares, generally accepted to mean 90 percent or more. Query whether this exclusion will apply where Acquireco already owns, for example, 20 percent of the Targetco shares and hence makes an offer for only the remaining 80 percent of the Targetco shares. The joint committee suggested that "common sense" dictated that the words "not already owned [by Acquireco]" should be read into the "all or substantially all" criterion.[50] The CRA has accepted this sort of interpretation with respect to similar language in subsection 186(2) of the Excise Tax Act,[51] and it is hoped that the same result will prevail in the context of the prescribed share rules.

An issue also arises when Acquireco proposes to purchase something less than all the Targetco shares. For example, Acquireco may be desirous of only acquiring majority control of Targetco (that is, 51 percent of the common shares) or achieving a 66 2/3 percent threshold. Acquireco may not, for example, wish to acquire any non-voting shares of Targetco. While such an offer may nevertheless constitute a takeover bid for the purposes of applicable securities laws,[52] the exclusion from the specified person definition in regulation 6204(3) " " may not be available, given that the offer by Acquireco is for less than 90 percent of the shares of Targetco.

In cases where there is uncertainty as to whether the relief provided by regulation 6204(3) " " will be available, consideration should be given to structuring the transaction, if commercially feasible, so that Targetco options survive post-transaction or are exchanged, pursuant to subsection 7(1.4) " ", for options of Acquireco, rather than forcing the option holders to exercise or surrender in the face of the acquisition.

2008 CR p.15:15-16 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Forced Cashout of Options

Often, it is desirable for Targetco options to be terminated such that they do not survive post-acquisition. In those circumstances, where the acquisition proceeds by way of plan of arrangement, a cleanup step in such a plan provides for the termination of unexercised options in exchange for a cash payment to the option holder equal to the in-the-money value of the options. This treatment raises a potential issue in relation to the availability of the paragraph 110(1)(d) " " deduction to those former option holders. In particular, the longstanding position of the CRA has been that the 50 percent deduction will be available only when it is the option holder's choice, not the employer's, to surrender the option for cash.[53] Where the cashout occurs automatically as part of the plan of arrangement, it appears that this requirement will not, technically speaking, be met. Arguably, however, this was not the CRA's intent, and its administrative requirement should not be read in such a manner. |

The basis for the CRA's view that the choice to surrender must be the employee's appears to be directed at ensuring that the employer has an obligation to issue shares pursuant to the option in order to ensure that section 7 " " applies. This requirement is logical in the context of a continuing and operating stock option plan; but perhaps it is not mandated in circumstances where the plan is going to be terminated, since, at the time the option was granted and during its term, the employer would have had an obligation to issue shares, thus falling within the section 7 regime. However, given the lack of authority on this point, employee option holders should nevertheless be advised to ensure that they exercise or surrender their Targetco options prior to the plan of arrangement to ensure their eligibility for the deduction under paragraph 110(1)(d) " ".

2008 CR p.15:16 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Early Cashout of DSUs

A termination of an RSU/RTU award or an SAR/TAR award and concurrent early payout of such an award should not give rise to any adverse tax issues, other than the obvious tax liability inherent in the employee receiving the payment. However, a potential issue arises in relation to the early cashout of DSUs. In particular, one of the requirements of regulation 6801(d) " " that must be satisfied to ensure that the DSUs do not constitute a salary deferral arrangement is that the payment in respect of the DSUs cannot be made until after the time of the "employee's death or retirement from, or loss of, the office or employment." Where the DSUs are the subject of early redemption as a consequence of an acquisition of the grantor corporation, but without cessation of the employment relationship, the question is whether this violation of regulation 6801(d) leads to the DSUs becoming taxable in the year of the cashout or retroactively to the year of grant because, with the benefit of hindsight, the requirements of regulation 6801(d) are not met. Arguably, the taxable event should occur at the time of the cashout event, so long as the cashout event was not reasonably foreseeable at the time of the grant of the DSUs and so long as the DSUs met the requirements, at the time they are granted, of regulation 6801(d).[54]

2008 CR p.15:16/17 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Rollovers of Phantom Units

In contrast to stock options and the protection offered by subsection 7(1.4) " ", there is no provision in the Act providing a tax-deferred rollover for phantom stock units or comparable rights. Thus, in any transaction where the equity structure of the grantor entity (whether a corporation or an MFT) will be changed in a significant manner, difficult issues may arise in respect of outstanding phantom units, whether they be RSUs, RTUs, DSUs, SARs, or TARs, particularly where the commercial objective is for such equity-based awards to continue post-transaction (that is, where the units will not be cashed out and terminated). The obvious examples of transactions where such issues arise include the takeover of a corporation by another corporation, where the desire is for the phantom units of | the target to be exchanged for equivalent phantom units of the acquiror, and the conversion of an MFT into a corporation,[55] where the desire is for phantom units of the MFT to be exchanged for equivalent phantom units of the corporation.

Without an explicit rollover rule, the question that arises in any transaction where one phantom unit is substituted for another is whether the employee could be considered to have "received" an amount, within the meaning of section 5 " " or 6 " ", on the surrender of the old phantom units in exchange for the new phantom units. In such circumstances, it would be necessary to argue that the value of the new phantom units, particularly if not vested, was nil, such that a nil income inclusion would result. Historically, this potential issue has been largely ignored in practice on the basis that the substitution of one economic entitlement for another should not result in any economic gain at the time of the substitution. The CRA had, however, taken the position that the substitution of one phantom unit for another, or for a stock option, constituted a disposition of the phantom unit and a corresponding income inclusion for the employee.[56] Given this position, most grantor entities were left in the unenviable position of trying to amend the contractual arrangements surrounding the phantom units so as to not trigger a disposition or realization event under general principles of law.

More recently, however, the CRA seems to have backed away from this position, issuing various advance tax rulings providing for a rollover of phantom units where certain requirements are satisfied. The purpose of this portion of the paper is to outline some of the principles to be derived from those rulings, with a view to trying to compile a list of the requirements that should be met if one is trying to rely on the CRA's administrative position. The CRA's rulings can be conveniently categorized into three categories, each of which is summarily described below.

2008 CR p.15:17 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Exchange of SARs for Stock Options

Notwithstanding its earlier position, beginning in 2000, the CRA now accepts that the replacement of a SAR for a stock option does not result in an immediate tax event, on the basis that the section 7 " " regime should apply to the grant of the stock option, with the result that, pursuant to paragraph 7(3)(a) " ", an employee should be considered to have neither received nor enjoyed any benefit as a consequence of the termination of the SAR and the concurrent grant of the stock option.[57] The CRA does, however, often qualify this position by stating that the employee must not receive any other benefit as a result of the termination of the SAR and, further, that accelerated vesting could be seen as such an economic benefit. Notably, the CRA does not extend the same position to the exchange of DSUs for stock options.[58]

2008 CR p.15:17/18 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Exchange of RSUs or SARs for DSUs

The CRA has also considered the situation where employees were granted RSUs or SARs but could elect to exchange such units, in lieu of a cash payment under | such awards, for that number of DSUs having a value equal to the cash payment that the employee would otherwise have been entitled to. In that context, the CRA has provided positive rulings to the effect that, so long as the DSUs meet the requirements of regulation 6801(d) " " and the employee's election was made prior to the time any payments would be made or vesting would occur under the RSUs or SARs,[59] the exchange of such units for DSUs does not result in any immediate income inclusion for the employee.[60]

2008 CR p.15:18 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Exchange of DSUs for new DSUs

The CRA has also considered situations where employees are permitted to exchange one type of DSU (referable in value to a particular type of share) for another type of DSU (referable in value to a different type of share, generally of a related corporation). The CRA has confirmed that in those scenarios such an exchange does not result in an income inclusion for the employee holder, provided that the FMV of the new DSUs does not exceed the FMV of the old DSUs at the time of the exchange and that the other requirements of regulation 6801(d) " " are satisfied at the time of the exchange.[61]

2008 CR p.15:18 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Summary

In the majority of the circumstances described above, the exchange of one type of phantom unit for another has occurred within the ongoing operation of the business of the grantor corporation, and not in the context of a reorganization transaction. That being the case, it is not entirely clear whether the same reasoning will apply when the phantom units of Targetco are exchanged for similar phantom units of Acquireco. On the basis that the same general principles should apply in that situation, the following requirements should, at a minimum, be met when any such exchange is structured, so as to increase the likelihood of falling within the CRA's administrative views:

1) The exchange should be structured so that it occurs at a time when the holder does not have any right to a payment under the existing phantom units.
2) No consideration, other than the new phantom units, should be received by the holder in exchange for the old phantom units.
3) The value of the new phantom units (determined immediately after the exchange) cannot exceed the value of the old phantom units (determined immediately before the exchange).
4) The terms and conditions, including those with respect to vesting, of the new phantom units should mirror, to the extent possible, the terms and conditions of the old phantom units.
5) At the time of the exchange, the entity that granted the old phantom units should be related to the entity that grants the new phantom units. |

2008 CR p.15:19 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

SIFT Conversions: Potential Issues

2008 CR p.15:19 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Background

Finance[62] has released proposed amendments to the Act to facilitate the conversion of certain specified investment flowthrough (SIFT) entities—namely, publicly listed MFTs—into corporations on a generally tax-deferred basis ("the SIFT conversion proposals").[63] The SIFT conversion proposals, together with the new taxing regime for SIFT entities first announced on October 31, 2006, have been the subject of detailed discussion at this conference[64] and earlier65, and such a discussion will not be repeated here. Rather, the focus of this portion of this paper is on certain issues that may arise in relation to outstanding trust unit options granted by an MFT that is converting into a corporation.

By way of background to the discussion, the SIFT conversion proposals generally contemplate two ways of converting a publicly traded MFT into corporate form on a tax-deferred basis. The first ("the distribution alternative") involves the distribution of shares of a taxable Canadian corporation (New Pubco) owned by the MFT to the public unitholders of the MFT on the winding up of the MFT and the redemption of the outstanding trust units pursuant to proposed subsection 107(3.1) " ", such that the public unitholders become shareholders of New Pubco and the MFT is wound up. The second alternative ("the unit exchange alternative") involves the transfer by the public unitholders of the MFT of their trust units to a taxable Canadian corporation (New Pubco), potentially using the tax-deferred rollover provisions of proposed subsection 85.1(8) " ", in exchange for treasury shares of New Pubco, with the result that the public unitholders become shareholders of New Pubco and New Pubco becomes the sole unitholder of the MFT, which is subsequently wound up into New Pubco under either proposed section 88.1 " " or subsection 107(3.1).[66]

To date, the majority of conversion transactions have been structured so that the MFT options become options to acquire shares of New Pubco,[67] giving rise to the various issues discussed below. For simplicity, the discussion that follows assumes that the relevant conversion transaction is structured on a one-for-one basis (that is, for every one MFT unit held by a public unitholder pre-conversion, that unitholder will end up holding one New Pubco share). It is also assumed that the conversion of options to acquire MFT units into options to acquire shares of New Pubco constitutes a disposition of the MFT option in exchange for the New Pubco option,[68] such that the option exchange must occur within the parameters of subsection 7(1.4) " ".[69]

Subsection 7(1.4)

Subsection 7(1.4) " " provides a rollover rule for employee stock options when certain conditions are satisfied. If the rule is applicable to an option exchange, an employee will be deemed not to have disposed of the old MFT option and not to have acquired the New Pubco option.[70] Further, the New Pubco option will be deemed | to be the same option or a continuation of the exchanged MFT option for most purposes,[71] including the purposes of paragraph 110(1)(d) " ".[72] The SIFT conversion proposals make only one proposed amendment vis-à-vis trust unit options, in the form of new subparagraph 7(1.4)(b)(vi) " ", which permits a tax-deferred rollover of MFT options for options granted by a "SIFT windup corporation" in certain circumstances. Although this proposed amendment facilitates such option exchanges, it gives rise to certain timing and other issues, described below. It should be noted that none of these issues are significant impediments to the option exchange; rather, the intent of this portion of the paper is to highlight the items to be considered.

In the context of most transactions involving the conversion of an MFT into a New Pubco, the requirements for a subsection 7(1.4) " " rollover of MFT options for New Pubco options can be summarized as follows (assuming that the SIFT conversion proposals are implemented in the form currently proposed). For simplicity, the following discussion assumes that the option holder has not paid any amount to acquire the MFT option under consideration.

2008 CR p.15:20 Equity-Based Employee Compensation (Nijhawan, A. & S. Sicker)

Paragraph 7(1.4)(a)

Pursuant to paragraph 7(1.4)(a) " ", the option holder must dispose of his or her rights to acquire trust units of an MFT. Read in conjunction with proposed subparagraph 7(1.4)(b)(vi) " ", this requirement mandates that the converting trust qualify as an MFT at the time of the option exchange. Under either of the conversion transactions contemplated by the SIFT conversion proposals, as soon as the public unitholders become shareholders of New Pubco, the MFT will cease to qualify as an MFT within the meaning of subsection 132(6) " " because it will have ceased to comply with the condition in paragraph 132(6)(c) " " relating to prescribed conditions.[73] That failure notwithstanding, the relieving rule in subsection 132(6.2) " " permits a trust that qualified as an MFT at the beginning of a year to retain that status throughout that year where the loss of status would otherwise have resulted solely from breach of such prescribed conditions. Consequently, so long as the conversion is structured properly, it should be possible for the MFT to maintain its status at the time of the option exchange, whether that exchange occurs before or after the exchange of MFT units for shares, and until December 31 of the year in which the conversion transaction occurs.

2008 CR p.15:20/21 Equity-Based Employee Compensation (Nijhawan, A. & S. Sicker)

Paragraph 7(1.4)(b)

Pursuant to paragraph 7(1.4)(b) " ", the option holder must receive no consideration for the disposition of the MFT options other than the New Pubco options. It is assumed that this requirement will be met. More significantly, however, either New Pubco must be a corporation that does not deal at arm's length with the MFT immediately after the option exchange,[74] or the MFT options must be options to acquire equity securities in a SIFT windup entity that was, at the time of the | option exchange, an MFT, and New Pubco must be a SIFT windup corporation in respect of the SIFT windup entity.[75]

Turning first to the non-arm's-length element, subsection 7(1.11) " " provides the following restrictive interpretation:

> For the purposes of this section, a mutual fund trust is deemed not to deal at arm's length with a corporation only if the trust controls the corporation.[76]

Thus, for the purposes of the subsection 7(1.4) " " rollover, a non-arm's-length relationship will exist between MFT and New Pubco immediately after the option exchange only if MFT controls New Pubco after the option exchange. In any other circumstance where one would ordinarily think of MFT and New Pubco as dealing at non-arm's length—for example, where New Pubco controls MFT—the non-arm's-length requirement will not be satisfied for the purposes of section 7 " ".[77] As a consequence, it will only be possible to rely on this element of the subsection 7(1.4) test if New Pubco is originally controlled by MFT—that is, New Pubco is initially a subsidiary of MFT.[78] It does not seem possible to rely on this portion of the test if New Pubco is a pre-existing acquiror corporation. In addition, from a timing perspective, even if New Pubco is initially a subsidiary of MFT, the test will be satisfied only if the conversion transaction is structured so that the option exchange occurs *before* the transaction by which the public unitholders become shareholders of New Pubco. A review of conversion transactions completed prior to the release of the SIFT conversion proposals indicates that the option exchanges in such transactions were structured in reliance on this test.[79]

Where it is not possible, or where it is commercially undesirable, to structure the option exchange so that it occurs before New Pubco ceases to be a subsidiary of MFT, the alternative is to fall within the requirements of proposed subparagraph 7(1.4)(b)(vi) " ", which was introduced as part of the SIFT conversion proposals. As noted above, to meet this requirement, the MFT must constitute a "mutual fund trust" that is a SIFT windup entity and New Pubco must constitute a SIFT windup corporation in respect of the MFT. In respect of the requirement that the MFT be a SIFT windup entity, reference must be made to the proposed definition in subsection 248(1) " ":

> "SIFT wind-up entity" means a trust . . . that at any time in the period that began on October 31, 2006 and that ends on July 14, 2008 is
>
> (a) a SIFT trust (determined without reference to subsection 122.1(2) " ").

It is generally expected that the converting MFT will constitute a SIFT windup entity for these purposes.[80]

2008 CR p.15:21/22 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Turning next to the requirement that New Pubco constitute a SIFT windup corporation, the proposed definition in subsection 248(1) " " provides as follows:

> "SIFT wind-up corporation," in respect of a SIFT wind-up entity, means at any particular time a corporation, |
>
> (a) that, at any time that is after July 13, 2008 and before the earlier of the particular time and January 1, 2013, owns all of the equity in the SIFT wind-up entity, or
>
> (b) shares of the capital stock of which are at or before the particular time distributed on a SIFT trust wind-up event of the SIFT wind-up entity.

It should be possible to structure a conversion transaction so that New Pubco will (1) satisfy the requirements of paragraph (a) of the foregoing definition in a conversion transaction structured under the unit exchange alternative or (2) satisfy the requirements of paragraph (b)[81] in a conversion transaction structured under the distribution alternative. From a timing perspective, however, because of the phrase "before the particular time" in the definition of a SIFT windup corporation, the definition will be satisfied only after the time that the public unitholders of MFT become shareholders of New Pubco. Thus, to ensure a rollover of MFT options for New Pubco options pursuant to subsection 7(1.4) " ", the conversion transaction must be structured so that the option exchange occurs *after* the transaction by which the public unitholders become shareholders of New Pubco. Various conversion transactions have been announced or completed on this basis.[82]

2008 CR p.15:22-23 Equity-Based Employee Compensation (Nijhawan, A. & S. Sicker)

Paragraph 7(1.4)(c)

The last requirement that must be satisfied to obtain a subsection 7(1.4) " " rollover of MFT options for New Pubco options is that the amount by which the "total value" of the New Pubco shares subject to the New Pubco option exceeds the "amount payable" under that option must not exceed the amount by which the "total value" of the MFT units subject to the old MFT option exceeds the "amount payable" under that option. This requirement essentially requires maintenance of the in-the-money amount of the option on the rollover.

Given current market conditions and the decrease in market values occurring in the value of trust units after the SIFT tax regime was first announced, many trust unit options may, at the time of an option exchange, be underwater. The maintenance of the in-the-money amount of such options on an option exchange should not be an issue. In particular, if both the New Pubco option and the old MFT option are underwater at the time of exchange, the fact that the New Pubco option is not as far out of the money as the old MFT option should not prevent the use of subsection 7(1.4) " ".

More care will need to be taken in respect of in-the-money options to ensure the maintenance of the economic benefits under the option, particularly where the market trading price of the New Pubco shares, immediately after the conversion transaction, differs from (is higher than) the market trading price of the MFT trust units immediately prior to the conversion.[83]

This third requirement may give rise to unique issues in the conversion context when the converting MFT has granted options the exercise price of which | is adjustable on the happening of certain events. This type of feature in an MFT trust unit option plan also raises other interesting issues, some of which are explored below.

2008 CR p.15:23 Equity-Based Employee Compensation (Nijhawan, A. & S. Sicker)

Adjustable Exercise Price Mechanism

2008 CR p.15:23 Equity-Based Employee Compensation (Nijhawan, A. & S. Sicker)

Background

For a distribution-oriented MFT, the grant of trust unit options has historically been viewed as a non-ideal employee compensation mechanism, since the performance of such an MFT is more typically assessed on a cash yield rather than unit price capital appreciation. As a consequence, in circumstances where significant capital appreciation was not expected, many MFTs adopted trust unit option plans where options were granted with an initial exercise price equal to the market value of the underlying trust unit but then were subject to a mechanism whereby the exercise price was reduced depending on the performance of the trust units. Such a downward adjustment could mean, for example, that once the MFT's distributions to unitholders exceeded a specified percentage (say, 8-10 percent) of a specified line item (such as, property, plant, and equipment) on the MFT's balance sheet, on a per-unit basis in a calendar year, the exercise price of the options would be reduced by a corresponding amount per unit.[84] As a consequence, the exercise price of options granted under this type of plan is based on the market price of the trust units on the date of grant and the unit distribution levels subsequently achieved by the MFT.

Under these sorts of plans, the option holders indirectly participated in any trust unit distributions; but, to the extent that the downward adjustment in exercise price was automatic, the negative consequence was the loss of the 50 percent deduction pursuant to paragraph 110(1)(d) " ". This was particularly troubling in circumstances where the economic benefit of the reduced exercise price did not offset the loss of capital-gains-like treatment on the exercise of the option. To deal with the issue, the mechanism evolved, in the case of some MFTs, as a downward adjustment in exercise price only at the positive election of the option holder; the election was to be made when the option holder chose to exercise (or surrender) the option.[85] It is generally accepted that where an option contains such an elective exercise price adjustment, the paragraph 110(1)(d) deduction is available on the exercise of the option, to the extent that the option holder elects to pay the original exercise price of the option and does not utilize the possibility of the reduced exercise price,[86] although there is some controversy on the availability of this deduction when such an option is surrendered.[87]

2008 CR p.15:23/24 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Subsection 7(1.4) Rollover

In the context of a conversion transaction where an option exchange is desired, the existence of an optional exercise price feature gives rise to several issues, including whether the feature should be included in the New Pubco options and | how the subsection 7(1.4) " " rollover operates when the exercise price (that is, the "amount payable") of the option is not yet determined. As a commercial matter, the inclusion of this type of feature is highly unusual in the stock option plan of a public company, particularly one that professes (as many of the successors to MFTs do) to be growth-oriented.

In the context of the subsection 7(1.4) " " rollover, the issue is the requirement in paragraph 7(1.4)(c) " " that the in-the-money value of the option be retained on the exchange, having reference to the total value of the securities that can be acquired under the option and the amount payable under the option to acquire such securities. Where an adjustable exercise price mechanism of the type described above is in place, the amount payable under the existing MFT option (or under the new option if the feature is continued in New Pubco) will not be a known quantity at the time of the option exchange, making it difficult to confirm that the requirements of paragraph 7(1.4)(c) will be satisfied.[88] It seems that there are at least two potential approaches to clarify this issue.

The first, which provides the most certainty on the point, is to cause the MFT to amend the terms of its trust unit options to require the option holders to elect the mechanism that will be used to compute the exercise price of their options—that is, to crystallize the potential adjustment to the exercise price prior to the option exchange.[89] This should be a numerical exercise in which the option holder compares the value of the option under both alternatives and assesses the benefit of being entitled to claim the 50 percent deduction under paragraph 110(1)(d) " ". The MFT options are then exchanged for New Pubco options, with an exercise price equal to the established exercise price. The New Pubco options will not include the adjustable exercise price feature.[90]

A second alternative, which is administratively simpler, is to frame the option exchange in the plan of arrangement in such a way that the court deems the amount payable under the New Pubco options to be equal to the amount payable under the old MFT options.[91] In this way, one could argue that because the amount payable is deemed not to have changed, the requirements of paragraph 7(1.4)(c) " " are met, notwithstanding that the amount payable may not yet be capable of quantification. This argument may be difficult to make, however, given that New Pubco will not know the exercise price notwithstanding the court having deemed it to be the same as the exercise price of the MFT options.

2008 CR p.15:24-25 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Subsection 7(1.5)

Aside from the various issues described above, it is also to be expected that many MFTs that are considering a conversion transaction may have unitholders who are employees (or former employees) who acquired trust units pursuant to the exercise of an MFT option and were subject to the elective tax deferral pursuant to subsection 7(8) " ". In such circumstances, it will be desirable to structure the conversion so that when the former option holder exchanges the trust units for New Pubco shares, the deferral is preserved. |

This type of deferral is generally provided for in subsection 7(1.5) " ", which is intended to provide for the continuation of a deferral under subsection 7(8) when a former option holder exchanges securities that are subject to such a deferral for new securities. Unfortunately, as described below, it appears that this deferral will not be available in all conversion transactions, even those designed pursuant to the SIFT conversion proposals, although there seems to be no policy reason for this result.

In the context of a conversion transaction, the requirements for the subsection 7(1.5) continuing deferral can be summarized as follows:

- The MFT trust units were acquired by the former option holder in circumstances where subsection 7(8) applied.[92]

- The former option holder receives no consideration for the disposition of his or her MFT trust units other than New Pubco shares.[93]
- MFT and New Pubco must deal at non-arm's length immediately after the unit-for-share exchange.[94] Notably, unlike the proposed amendments to subsection 7(1.4) " " described above, the SIFT conversion proposals do not contain any proposed amendments to subsection 7(1.5) " " designed to facilitate the exchange of MFT trust units for shares of a SIFT windup corporation.
- The total value of the New Pubco shares received on the exchange must not exceed the total value of the MFT units so exchanged.[95] This raises the valuation issue described above in relation to subsection 7(1.4).

The most notable of these is the requirement in subparagraph 7(1.5)(b)(ii) " " that MFT and New Pubco deal at non-arm's length immediately after the unit-for-share exchange. As described above in the context of subsection 7(1.4), under the current wording of subsection 7(1.11) " ", this requirement will not be satisfied unless, immediately after the unit-for-share exchange, New Pubco is a controlled subsidiary of MFT. Where New Pubco is, at the beginning of the series, a new or pre-existing subsidiary of MFT, this requirement can be dealt with by having the unit-for-share exchange by former option holders occur as a preliminary step in the plan of arrangement at a time when the MFT continues to own the majority of the voting shares of New Pubco. However, it does not seem possible to satisfy the requirements of this provision if New Pubco is not a subsidiary of MFT (for example, in an acquisition context). It is hoped that Finance will correct this oversight in the SIFT conversion proposals.[96]

2008 CR p.15:25/26 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Dealing with Underwater Awards

No purported discussion of topical issues in equity-based compensation would be complete without reference to mechanisms of dealing with underwater awards. The issue comes to prominence in any time of economic downturn, when many employees end up holding options, SARs, or TARs with an exercise price or base value that is greater than the FMV of the underlying security. Similar issues arise | in respect of RSUs, RTUs, and DSUs when the value of the unit is not as high as originally anticipated. This is clearly the result in many public corporations and MFTs, particularly after the market crashes in the fall of 2008. In such circumstances, it is questionable whether such awards continue to serve their purpose of encouraging employees to maximize shareholder value. Perhaps just as significantly, the existence of underwater awards may be adverse to employee retention, since employees may believe themselves to be better off by walking across the street, where they would at least be granted new awards with exercise prices that better reflect current market conditions.

2008 CR p.15:26 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Repricing Options

Where it is determined to be necessary to reprice options, the general intention is to reduce the exercise price of the option to an amount equal to the current trading price of the underlying security. Repricing is essentially a business decision involving competing philosophical theories, and the rules in the Act generally exist to facilitate such initiatives.

From a tax perspective, the critical element in repricing options is to ensure that the option holder continues to be eligible for the 50 percent deduction provided for by paragraph 110(1)(d) " " on the exercise or surrender of the option. There are currently two mechanisms available to accomplish the objective.

2008 CR p.15:26 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Option Exchange

One can accomplish a repricing simply by cancelling the original options and granting, in consideration therefor, new options with a repriced exercise price. Such an option exchange should be governed by subsection 7(1.4) " ", so long as the in-the-money amount of the new options is not greater than the in-the-money amount of the original options. If the issue arose because the original options were underwater and the new exercise price is equal to the FMV of the underlying securities at the time of the option exchange, this requirement will be met. In such circumstances, the 50 percent deduction under paragraph 110(1)(d) " " should, to the extent that it was available in respect of the original options, be available pursuant to subparagraph 110(1)(d)(iii) " ".

2008 CR p.15:26/27 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Straight Repricing

It is also possible to effect a repricing simply by amending existing option agreements to provide for the reduced exercise price. On the basis of the decision in *Amirault*,[97] such an amendment should not constitute a disposition of the option.[98] Although this approach is generally thought to be preferable from a commercial perspective,[99] the difficulty is that under current law it causes the loss of the deduction under paragraph 110(1)(d) " ", since the exercise price of the option will be reduced to an amount below the FMV of the underlying security determined at the time that the option was originally granted.[100] In response to criticisms that | this result was inappropriate from a policy perspective, in 2002 the Department of Finance introduced draft amendments to add subsections 110(1.7) " " and (1.8) to the Act, effective for taxation years after 1998. Proposed subsection 110(1.7) provides that where the conditions in proposed subsection 110(1.8) are met, the originally priced option will be deemed to have been disposed of for the repriced option. The conditions in proposed subsection 110(1.8) are that (1) in the absence of subsection 110(1.7), the paragraph 110(1)(d) deduction would not have been available, and (2) had the repricing occurred by virtue of an actual option exchange pursuant to subsection 7(1.4) " ", the paragraph 110(1)(d) deduction would be available. The result of this deeming rule is that the repricing will be treated as an option exchange pursuant to subsection 7(1.4) without an actual exchange having occurred.[101]

Notwithstanding that the proposed amendments have been in draft form since 2002, they have not yet been enacted, although they are intended to apply retroactively to repricing that occurs after 1998.[102] The CRA indicated in 2001 and 2002 that it will not reassess on the basis of current paragraph 110(1)(d) except in situations of abuse,[103] but that taxpayers should contact their local Tax Services Office when claiming the deduction. Until the amendment is actually in force, corporations and MFTs instituting a price reduction in this manner may wish to obtain some soft comfort from the local TSO in this regard.

2008 CR p.15:27 Equity-Based Employee Compensation (Nijhawan, A. & S. Sicker)

Transfer of Underwater Options to a Tax-Free Savings Account

Another potential way to obtain value, in some form, from underwater options is to allow option holders to transfer such options to a tax-free savings account (TFSA). Under the current rules, a stock option of a public corporation is a qualified investment for a TFSA,[104] so long as the option holder is not a specified shareholder of the corporation.[105] When an underwater option is contributed to the TFSA, it is arguable that the contribution will have only nominal value, based on the CRA's administrative positions which have accepted that the value attributable to a stock option transferred to an RRSP is equal to the difference between the value of the shares that can be acquired under the option and the exercise price of the option.[106] Pursuant to paragraph 7(1)(c) " ", the option holder will not incur any tax liability at the time of the transfer. As market conditions improve and the options go up in value, the TFSA can exercise (or, if permitted, surrender) the option, at which time the option holder will incur liability for the resulting tax under section 7 " ". The benefit of this strategy is not to avoid paying tax on the option benefit itself, but rather to expand the amount that can potentially grow tax-free in the TFSA.[107]

2008 CR p.15:27/28 Equity-Based Employee Compensation (Nijhawan, A. & S. Sicker)

Repricing Phantom Units

In the case of SARs and TARs, it should be possible to simply amend the base value of such units to reflect market conditions. Again, in reliance on *Amirault* | (or on the rollover principles espoused above), this should not result in any adverse tax issues to the holder.

Because RTUs and RSUs are based on the whole value of the underlying security, the only way to compensate holders from a drop in economic value is to grant an additional bonus, perhaps in the form of additional RTUs or RSUs. Such a bonus is not possible in respect of DSUs, however.[108]

2008 CR p.15:28 Equity-Based Employee Compensation (Nijhawan, A. & S. Sicker)

Deductibility Issues: Recent Cases

On November 14, 2007, the Tax Court of Canada released the decision of Bowman CJ in *Shoppers Drug Mart*.[109] This decision, which has not been appealed, represents an important development in the jurisprudence relating to the deductibility of payments made by a corporate employer for the cancellation of employee stock options in the course of an acquisition or reorganization of the employer.

In the typical scenario directly affected by this decision, an acquiror seeks to obtain the entire share capital of a target and wants all options to be extinguished prior to the transaction. The target, seeking to eliminate all options while simultaneously ensuring that the option holders, who are typically employees, receive some of the economic benefit of the acquisition, will offer to pay the employees an amount equal to the in-the-money value of their options.[110] Depending on the particular stock option plan, the option to receive payment of such an amount may also be automatically triggered on a change of control.[111] The question that then arises is whether or not the target will be entitled to a deduction for this cash payment to employees.

2008 CR p.15:28-29 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

The Statutory Provisions

The statutory scheme governing the deductibility of cash payments for employee stock options is composed of paragraph 7(3)(b) " ", subsection 9(1) " ", and paragraph 18(1)(b) " " of the Act.[112] These provisions establish that cash payments under employee stock option plans are generally deductible by employers as current expenditures.

The general provision governing the taxation of employee stock options is section 7 " " of the Act. Of potential relevance in the context of cash payments to employees for the surrender of options is paragraph 7(3)(b), which prohibits an employer from taking a deduction in connection with the sale or issue of its shares to its employees. However, this paragraph does not apply where cash payments are made to option holders, since shares are not sold or issued to an employee in circumstances where a cash payment is made. Therefore, the relevant provisions of the Act are subsection 9(1) and paragraph 18(1)(b).

Subsection 9(1) provides that a taxpayer's income for a taxation year from a business is the taxpayer's profit from that business. Profit is inherently a net concept that presupposes business expense deductions.[113] As a result, in the normal course, payments to employees are a deductible business expense. Pursuant | to paragraph 18(1)(b), however, no deduction is permitted in respect of an outlay of or a payment on account of capital except as expressly permitted by part I of the Act. The dispute that therefore arises between taxpayers and the CRA is whether cash payments are or are not outlays of or payments on account of capital, since payments on account of capital made to employees for the surrender of their stock options are not deductible in computing the employer's profit.

2008 CR p.15:29 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

The CRA's Published Position

The CRA's longstanding position in respect of cash payments made under option plans was that cashout payments made in the ordinary course are in the nature of an employment compensation expense and accordingly are deductible pursuant to subsection 9(1) " ". Although this position originated before the Federal Court of Appeal decision in *Kaiser*,[114] the CRA subsequently confirmed that it continued to endorse the position except in certain circumstances, such as those in *Kaiser*. Specifically, the CRA set out its position as follows:

> In our view, the result in *Kaiser* follows from the facts in that particular case and is not inconsistent with our position that the payment by an employer of cash rather than shares pursuant to the terms of a stock option plan will, in the absence of evidence to the contrary (e.g. the fact situation in *Kaiser*) . . . be a deductible expense to the employer.[115]

The CRA's position was relied upon by taxpayers and their advisers as recognition by the CRA that where employees holding options to acquire shares under an employee stock option plan are entitled to receive cash in lieu of shares under the terms of the plan and elect to receive cash payments, the cash payments are deductible to the employer.

At the same time, it was an open question as to when exactly the *Kaiser* fact situation would be considered to exist and whether an employer would or would not be entitled to a deduction in circumstances where the employee had the right to choose cash instead of shares but the choice arose in the context of an acquisition or reorganization of the capital of the company.

2008 CR p.15:29-30 Equity-Based Employee Compensation (Nijhawan, A. & S. Sicker)

Kaiser and Canada Forgings

Given the CRA's position that cash payments in lieu of shares under an employee stock option plan are generally deductible but may not be deductible in fact situations similar to that in *Kaiser*, considerable effort was devoted to understanding the cases that established the exception to the more general principle. The two main cases were *Kaiser* and *Canada Forgings*.[116]

In *Canada Forgings*, the employer corporation had entered into stock option agreements with two senior executives (the president and vice-president). Those same two employees were the only shareholders of a private company which owned 85 percent of the shares of the employer. An arm's-length purchaser sought | to acquire all of the shares of the employer corporation, and as part of the acquisition the purchaser and the two employees entered into a separate agreement under which both of the employees agreed to surrender their options in exchange for an amount equal to the in-the-money value of the options. In computing its income under the Act, the employer treated these payments as deductible compensation expenses. At trial, the Federal Court held that the payment was capital in nature, primarily on the basis that the payment was non-recurring and was made at a time when the purchaser was attempting to acquire all of the shares of the employer, and that its large size indicated it was capital in nature.

In *Kaiser*, Ashland US agreed to sell the shares of its Canadian subsidiary, Ashland Canada, to Kaiser Resources, an arm's-length purchaser. In the sale agreement, the vendor undertook to make a cash offer to the option holders equal to the difference between the exercise price per share under the option and the per-share price that Kaiser Resources was offering to pay Ashland US for its shares of Ashland Canada. In addition, all unvested options were to be accelerated so that they would become immediately exercisable. Shortly after executing the sale agreement, Ashland Canada amended its stock option plan to remove any vesting restrictions and to allow cash payments to be made to option holders. A cash offer was made by Ashland Canada and was accepted by most of the option holders. The stock option plan was subsequently cancelled. The evidence presented at trial indicated that one of the purposes of the cashout payment was to ensure that key employees would stay with Ashland Canada after the sale by eliminating uncertainty about the new ownership and options. All of the shares of Ashland Canada were then acquired by Kaiser Resources. In computing its income, Ashland Canada deducted the option cashout payments as a current expense. Ashland Canada was successful in its initial appeal; the Federal Court Trial Division held that the payment was a deductible current expense on the basis that it was a bona fide payment made to employees in fulfillment of a condition of employment.

2008 CR p.15:30-31 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

However, the Federal Court of Appeal, in a unanimous judgment, overturned the trial decision. The court held that because the cancellation of the stock option plan was of lasting benefit to Ashland Canada and altered its capital structure, the payment was capital in nature:

> The respondent, in buying out rights under the plan, parted with an asset (the purchase price) and effected a sterilization of future issues of shares. The disbursement made was a once and for all payment which had a direct effect on the capital structure of the corporation. . . . Although the plan originated as a form of compensation and immediate compensation was one reason for its termination, and although the arrangement may appear to have been "seeming novations of the original deal," as characterized by the trial judge (probably since the compensation was in money terms instead of shares), it does not follow that the payment, from the point of view of the respondent, had the character of an operating expenditure. What is important is not the purpose pursued by the respondent but what it did and how it did it. . . . |
>
> Nevertheless, the compensation was made by means of a reshaping of the capital structure of the respondent's organization. This feature, in my view, dominates the whole set of circumstances revealed by the evidence and constitutes the guiding element.[117]

The reasoning in *Kaiser* suggested that any once-and-for-all payment that had a direct effect on the capital structure of the payer corporation would be rendered a non-deductible capital expenditure.[118] Payments made in the course of an acquisition or takeover arguably always had an impact on the capital structure of the target corporation, because the very purpose of such payments was to transfer complete ownership to the acquiror. Thus, the net result was that in most acquisitions the payments made to employees would not be deductible.

2008 CR p.15:31-32 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

Shoppers Drug Mart Limited

In view of the decisions in *Canada Forgings* and *Kaiser*, the decision of Bowman CJ in *Shoppers Drug Mart* came as something of a surprise, but also as a welcome development for employers that were making cashout payments to employees in the course of a takeover or capital reorganization. Although Bowman CJ clearly could not overrule the Federal Court of Appeal's reasoning in *Kaiser*, a close review of the decision indicates that his decision, coming as it did nearly 20 years after *Kaiser*, may have effectively eliminated the impact of *Kaiser* in many circumstances and may be intimating that a reconsideration of *Kaiser* is in order.

In *Shoppers Drug Mart*, British American Tobacco entered into an agreement with Imasco to acquire all of the shares of Imasco. As part of this acquisition, Imasco undertook to encourage all persons holding Imasco options to either exercise or surrender those options. Shoppers Drug Mart was a subsidiary of Imasco, and a number of Shoppers Drug Mart employees held Imasco options. A majority of those employees chose to surrender the options in exchange for a cash payment from Imasco. Shoppers Drug Mart in turn reimbursed Imasco for the payments made to its employees and sought to deduct the expense. The deduction was disallowed by the minister but allowed by Bowman CJ on appeal.

Assuming that Bowman CJ did not set out to overrule *Kaiser* but simply reached a different conclusion because of different facts, it is important to determine which facts in *Shoppers Drug Mart* formed the basis for the different outcome. In conducting this analysis, we are assisted by Bowman CJ's own summary of the facts that he considered relevant to the appeal.[119] Using the facts he identified as a template, we may therefore proceed on the basis that those are the facts most relevant to determining whether a payment for the surrender of options is a payment on revenue account or capital account.

Much of his focus is on the terms of the Imasco stock option plan, and he quotes significant portions of the plan, including the provision dealing with the election to surrender an option for cash instead of receiving shares: |

> Paragraph 10 of the Imasco SOP, as amended in 1995, read as follows:
>
> > 10. ELECTION TO SURRENDER OPTION FOR CASH (AVAILABLE IN CERTAIN CIRCUMSTANCES)
> >
> > From time to time, the Corporation may offer an Optionee the right to elect, at the Optionee's discretion, to surrender an option, or any portion thereof, in lieu of exercising same, and to receive upon such surrender a cash payment equal to the amount of the excess of the then market value of one Share over the purchase price per Share specified in the option multiplied by the number of Shares purchasable upon exercise of the option, or portion thereof, so surrendered. For this purpose, the market value of one Share shall be the closing price per Share on The Toronto Stock Exchange on the day the option, or portion thereof, is surrendered, or if Shares are not traded on The Toronto Stock Exchange on such day, then the next preceding trading day on which such a trade took place shall be used.[120]

He goes on to note that in 1999 this paragraph was amended to give the holder of the option the right to surrender the option for a cash payment, removing the discretion of the corporation to first make an offer.

2008 CR p.15:32-33 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

By contrast, the provisions of the *Kaiser* plan were very different. In *Kaiser*, there was no provision for option holders to receive cash in lieu of shares in any circumstances. Therefore, the

Kaiser plan had to be amended to provide for a cash payment. To the extent that this is a critical distinction, most modern plans provide employees with the option of receiving cash in lieu of shares. This may, by itself, entitle the employer to a deduction for the payment based on the *Shoppers Drug Mart* precedent.

A second relevant fact is that in *Kaiser*, the company had to take steps to accelerate the vesting of the options that were then paid out in cash. In *Shoppers Drug Mart*, it appears that Imasco accelerated the vesting of the options,[121] but it also appears that under the terms of the Imasco option plan, the acquisition of Imasco constituted a fundamental change, thereby automatically resulting in an acceleration of the vesting and payout of the rights under the Imasco option plan.[122] Again, if this is a critical distinction, many modern option plans that provide for acceleration of vesting on a fundamental change, such as an acquisition of control, may also entitle the employer a deduction based on *Shoppers Drug Mart*.

The third factor of importance relates to the structure of the payments. In *Shoppers Drug Mart*, it was clear that the option holders were free to choose to receive shares in Imasco or a cash payment.[123] Neither Imasco nor Shoppers Drug Mart was able to compel the shareholders to take cash as a way of forcibly buying out their rights under the plan. By contrast, it is clear from the facts in *Kaiser* that the option holders had no alternative prior to the changes made to accommodate the takeover to receive anything but shares. This is a fundamental difference: in the *Shoppers Drug Mart* situation, employees were simply exercising rights that had vested on an accelerated basis where such acceleration was | in itself a vested right of the employees. In *Kaiser*, by contrast, it is fair to say that the employer was making a payment to fundamentally alter the vested rights of employees once and for all. Put another way, the payment in *Kaiser* can be characterized as a payment to effectively terminate the existing rights of the employees. In *Shoppers Drug Mart*, the payments were made in accordance with the existing rights of the employees.

A fourth distinction to be drawn is that in *Kaiser* the sale agreement between Kaiser Resources and Ashland US contained a provision *requiring* Ashland Canada to make a cash offer to the option holders in order to eliminate their options.[124] By contrast, although Imasco may have *encouraged* option holders to exercise their options for shares or to surrender their options for cash, the obligation to make a cash payment arose not from the agreement with British American Tobacco but from the terms of the existing options, which gave the employees a right to a cash payment. It is arguable that the genesis of the cash payment in *Kaiser* was the takeover agreement, which required Kaiser to pay cash to eliminate the options. In *Shoppers Drug Mart*, the terms of the stock option plans themselves mandated the cash payments.

Although all of these distinctions are based on facts identified by Bowman CJ in his decision, it is worth noting that the final two distinctions mentioned above were specifically argued in *Shoppers Drug Mart*. Bowman CJ commented as follows:

> Counsel for the appellant in his written and oral argument drew a number of other

> distinctions between this case and *Kaiser*. He emphasized two however. The first was that in *Kaiser* the payment was made to terminate the stock option plan and here it was not. The second is that in *Kaiser* the genesis of the payment was the takeover agreement and here it was in the stock option plan itself. Whatever may be the merits of this second distinction it is sufficient to add that here, no lasting benefit of a capital nature was achieved by the payment.[125]

Although Bowman CJ pointedly did not comment on the "merits of the second distinction," it is clear that he was influenced by the first distinction—namely, that in *Kaiser* the payment was made to terminate the stock option plan, whereas for Shoppers Drug Mart "no lasting benefit of a capital nature was achieved by the payment."

A final distinction to be drawn between the *Kaiser* facts and the *Shoppers Drug Mart* facts is that in *Shoppers Drug Mart* the options were not in Shoppers Drug Mart itself, but in Imasco, the parent company, and the payment in question was made by Shoppers Drug Mart to reimburse Imasco for payments made by Imasco to Shoppers Drug Mart employees. In *Kaiser*, by contrast, the company was paying out its own options rather than reimbursing a parent for the pay out of the parent's options. This distinction is identified by Bowman CJ in the following passages from the *Shoppers Drug Mart* decision: |

> In *Kaiser* Desjardins, J.A. based her conclusion on the factual finding made by her that:
>
> > . . . The disbursement made was a once and for all payment which had a direct effect on the capital structure of the corporation. . . .
> >
> > Here, the rearrangement of the Imasco corporate structure did not impinge in any way on the corporate structure of SDM. Desjardins, J.A. appears to have felt that the cancellation of the stock option plan of the appellant, Kaiser Petroleum Ltd., was an advantage for the lasting benefit of the appellant. I do not see how a payment by SDM to Imasco to reimburse it for payments made to employees of SDM created or achieved anything of lasting benefit to SDM. The business of SDM went on as usual.[126]

This passage can be read as saying that the payment made by Shoppers Drug Mart was not on account of capital because it related to the capital structure of Imasco, and had nothing to do with the corporate structure of Shoppers Drug Mart itself. This is the narrow reading.

Although one can imagine an argument that this was the critical distinction between the *Kaiser* and *Shoppers Drug Mart* decisions, such an argument is not easily supported upon close review of the *Shoppers Drug Mart* decision. If the critical distinction was that the payment in *Kaiser* was on account of capital because the capital of *Kaiser* was being rearranged, whereas in *Shoppers Drug Mart* it was the capital of a different company being acquired, there would have been no reason for Bowman CJ to review the other salient features of the Imasco stock option plan. Indeed, when he refers to the two key distinctions urged upon him by counsel for Shoppers Drug Mart, it is telling to note that even the lawyers do not appear to have argued that this was the key distinction. Instead, it is clear from the decision that the key distinction for Bowman CJ was that in *Kaiser* there was a payment that fundamentally altered the capital structure of the company, whereas in *Shoppers Drug Mart* there was no fundamental alteration of anything. The payment in *Shoppers Drug Mart* was clearly within the existing corporate framework.

In summary, it is clear that the critical distinction is that the payment in *Kaiser* was made to terminate the stock option plan, thereby reshaping the capital structure of the company, whereas the payment in *Shoppers Drug Mart* was a payment made entirely within the context of an existing plan. As the opening words in the excerpt below indicate, the fact that the payment was made to reimburse Imasco was immaterial, and such a payment could have been made directly by Shoppers Drug Mart. To express the distinction in Bowman CJ's own words:

> The payment was made to reimburse Imasco for payments it made to SDM's employees *but the practical effect was identical to that which would have prevailed if SDM had made the payments directly to its employees.* It was the options issued by Imasco to acquire Imasco shares that were affected by the offer to pay for the surrender of the options. The option holders could exercise the options, surrender them for cash or do nothing. . . . |
>
> Desjardins, J.A. said in *Kaiser* that what was achieved by the extinguishment of the stock option plan was a benefit of an enduring nature to Kaiser. On the evidence before me I cannot make the same finding of fact that paying for the surrender of the Imasco options achieved a benefit of a lasting nature to SDM. . . .
>
> I close these reasons by repeating what Desjardins, J.A. said at the termination of her reasons:
>
>> In the case at bar, there is no evidence that the undertaking of July 11, 1978 was conditional to the sale agreement so as to ensure a share acquisition by Kaiser Resources Limited. There is, however, evidence that compensation was one element pursued when the termination of the Stock Option Plan took place. *Nevertheless, the compensation was made by means of a reshaping of the capital structure of the respondent's organization.* This feature, in my view, dominates the whole set of circumstances revealed by the evidence and constitutes the guiding element under the test set in the *B. P . Australia Ltd.* case cited above. [Emphasis added.]
>
> The feature which she set out, if I understand it correctly, evidently dominated all other considerations. No such dominant feature pointing in the direction of a capital expenditure exists in this case.[127]

The foregoing analysis suggests that in the majority of modern cases a cashout payment made to employees should be deductible because the terms of modern stock option plans are far more likely to resemble the *Shoppers Drug Mart* example than the *Kaiser* example. However, a more interesting question raised by the *Shoppers Drug Mart* decision is whether it in fact represents an attempt by Bowman CJ to signal that the jurisprudence in *Canada Forgings* and *Kaiser* is outdated and out of touch with modern economic reality. In the nearly 20 years since *Kaiser* and the nearly 25 years since *Canada Forgings*, the role of employee stock options has greatly evolved and expanded. Options were originally conceived of as a way to align the interests of shareholders and employees by giving the employees an opportunity to acquire a true ownership interest in the company, and for that reason options were generally reserved for only the most senior executives. Today, however, options are ubiquitous and are frequently granted to employees at all levels and without any real expectation that employees will participate in a meaningful way in the long-term ownership of the enterprise. In this modern context, the words of Bowman CJ may indicate a sensitivity to new business and economic realities as much as or more than an evolution in jurisprudence:

> I start from the premise that in the ordinary course a payment made by an employer to an employee for the surrender of his or her option under a stock option plan to acquire shares of the company is a deductible expense to the company. This conclusion is not based on any specific provision of the *Income Tax Act*. It is simply part of employee compensation and is therefore a cost of doing business under section 9 " ". |
>
> Why then does a payment to employees who are option holders become a capital expense just because it is made in the course of a corporate reorganization of the parent company? The short answer is that it does not. The business of SDM continued throughout the reorganization of the Imasco corporate structure. SDM, as a separate corporate entity, was not being reorganized. It had payrolls to meet and expenses to pay. It may possibly be that the reason for accelerating the vesting of the stock options was to enable as many employees as possible either to exercise their options or surrender them so that BAT could achieve its goal of obtaining all outstanding shares of Imasco. This does not turn the payment of what is patently a revenue expense into a capital expense.[128]

The question, then, to echo the words of Bowman CJ, is why a payment made to option holders becomes a capital expense simply because it is made in the course of a corporate acquisition. If the CRA wants to distinguish Bowman's reasoning in *Shoppers Drug Mart*, it could seek to do so on the basis that Bowman CJ asks whether a payment made in the course of a reorganization of a parent company is a capital expense. However, when one reads the criteria that Bowman CJ applies in determining whether or not the payment is a capital expense, it is clear that his comments are not necessarily limited to the very narrow situation where a parent corporation is being reorganized. Indeed, it is at least arguable that his comments represent a complete rejection of the *Kaiser* approach.

Fortunately, it is expected that this issue will be clarified in the near future. It is understood that pleadings have been filed before the Tax Court of Canada in *Imperial Tobacco Canada Ltd. v. The Queen*,[129] a case that asks whether the cash payments made in respect of Imasco options granted to Imasco's own emplopyees are a deductible expense. |

2008 CR 15 Footnotes Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

FOOTNOTES

2008 CR 15 Footnote-1 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

1 See, for example, Brad Severin, "Trends in Executive Compensation: Factors Driving Change and the Canadian Experience," in *2007 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2007), tab 10.

2008 CR 15 Footnote-2 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

2 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"), and the Income Tax Regulations, CRC 1978, c. 945, as amended. Unless otherwise stated, statutory references in this paper are to the corresponding provisions of the Act.

2008 CR 15 Footnote-3 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

3 The information in this paper is current to February 10, 2009.

2008 CR 15 Footnote-4 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

4 The discussion herein is limited to equity awards made by publicly traded vehicles to employees. While such awards can also be offered to consultants, the tax implications of such grants will differ significantly and are not discussed herein.

2008 CR 15 Footnote-5 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

5 Section 7 " " provides stock options and trust unit options with preferential tax treatment as compared with other equity-based awards—for example, the availability of capital-gains-like treatment pursuant to paragraph 110(1)(d) " " and the ability of the option holder to elect when the option will be exercised and tax will accordingly become payable. In contrast, the rules surrounding phantom unit awards are quite restrictive in terms of permissible vesting and exercise periods, and such awards are taxed at full employment income rates.

2008 CR 15 Footnote-6 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

6 Equity-based awards could also include stock savings plans and stock bonus plans, which are not discussed herein.

2008 CR 15 Footnote-7 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

7 RSUs and RTUs are generally based on a three-year bonus exception in paragraph (k) of the definition of "salary deferral arrangement" (SDA) in subsection 248(1) " ".

2008 CR 15 Footnote-8 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

8 DSUs are based on a specific exception to the SDA rules contained in regulation 6801(d) " ".

2008 CR 15 Footnote-9 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

9 Unlike holders of RSUs, RTUs, and DSUs, the holder of a SAR or TAR is only entitled to a payment of the appreciation value of the underlying security. So long as the SAR or TAR has no value at the date it is granted, the CRA generally accepts that the grant should be seen as a payment for future (not past) services and hence should not constitute an SDA.

2008 CR 15 Footnote-10 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

10 For background, see, for example, Terri Spadorcia and Anne Montgomery, "Equity Compensation: Emerging Trends," in *Report of Proceedings of the Fifty-Sixth Tax Conference*, 2004 Conference Report (Toronto: Canadian Tax Foundation, 2005), 24:1-26.

2008 CR 15 Footnote-11 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

11 Clause 110(1)(d)(ii)(A) " ".

2008 CR 15 Footnote-12 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

12 "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Ninth Tax Conference*, 1987 Conference Report (Toronto: Canadian Tax Foundation, 1988), 47:1-103, question 22, at 47:17. See also CRA document no. 9321835, August 26, 1993, and, more recently, CRA document no. 2005-0112901E5, April 25, 2005.

2008 CR 15 Footnote-13 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

13 CRA document no. 5-5180, February 17, 1988.

2008 CR 15 Footnote-14 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

14 Ibid. (emphasis added).

2008 CR 15 Footnote-15 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

15 CRA document no. 2006-0217401I7, May 29, 2007.

2008 CR 15 Footnote-16 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

16 To a similar effect, G.H.L. Fridman, *The Law of Contract in Canada*, 5th ed. (Toronto: Thomson Carswell, 2006), at 5, states:

> Contract is a jural relation that is founded upon agreement, that is, upon the manifestation of a mutual concordance between the parties as to the existence, nature and scope of their rights and duties. A contract is a legally recognized agreement between two or more persons, giving rise to obligations that may be enforced in the courts. By such an agreement the parties not only restrict their present or future freedom to act, by the limitations imposed upon themselves by the agreement: they are creating a legal rule, or set of legal rules, a legal regimen, binding as regards themselves and only themselves."

Fridman goes on to note, ibid., at 6-7, that as a matter of law, certain kinds of agreements cannot be regarded as constituting contracts, such as certain family agreements, offers of assistance to charity, religious vows or undertakings of help, and cooperation with friends in a social context.

2008 CR 15 Footnote-17 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

17 *Black's Law Dictionary*, 8th ed. (2004).

2008 CR 15 Footnote-18 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

18 83 DTC 5136 (FCTD); aff'd. 84 DTC 6535 (FCA).

2008 CR 15 Footnote-19 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

19 97 DTC 1097 (TCC).

2008 CR 15 Footnote-20 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

20 Ibid., at 1108 (emphasis added).

2008 CR 15 Footnote-21 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

21 2001 DTC 942, at paragraphs 23-25 and 36 (TCC) (emphasis added).

2008 CR 15 Footnote-22 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

22 Supra note 16, at 13-14.

2008 CR 15 Footnote-23 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

23 Jasmine Sidhu, "The Effect of Restrictions on the Exercise of Stock Options" (2005) vol. 16, no. 7 *Taxation of Executive Compensation and Retirement* 522-24.

2008 CR 15 Footnote-24 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

24 John D. McCamus, *The Law of Contracts* (Toronto: Irwin Law, 2005), 619.

2008 CR 15 Footnote-25 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

25 Fridman, supra note 16, at 425.

2008 CR 15 Footnote-26 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

26 [1959] SCR 578, at 583-84 (emphasis added).

2008 CR 15 Footnote-27 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

27 85 DTC 5045 (FCA). In this case, the issue was whether amounts to be paid under an agreement of purchase and sale were receivable when the agreement was signed, as the taxpayer contended, or when the transaction closed. The court found that one of the terms of the agreement, requiring compliance with the provincial Planning Act, represented a "true condition precedent" because it was dependent on an external event in the control of third parties.

2008 CR 15 Footnote-28 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

28 96 DTC 6529 (FCA).

2008 CR 15 Footnote-29 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

29 See also *Kempling v. Hearthstone Manor Corp.* (1996), 184 AR 321 (CA).

2008 CR 15 Footnote-30 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

30 See also, for example, *Gyulay v. Kenderry Corp.* (1999), 24 RPR (3d) 84 (Ont. Gen. Div.).

2008 CR 15 Footnote-31 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

31 See, for example, *Genern Investments Ltd. v. Back et al.*, [1969] 1 OR 694 (HCJ), and *Yorkwood Homes v. Law Development Group*, [1998] OJ no. 4425 (Gen. Div.).

2008 CR 15 Footnote-32 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

32 Some of the analysis in this section of the paper is based on Anu Nijhawan, "Stock Option Deduction Under Paragraph 110(1)(d) " ": Unexpected Issues Arising in the Context of Corporate Acquisitions" (2006) vol. 17, no. 10 *Taxation of Executive Compensation and Retirement* 687-92.

2008 CR 15 Footnote-33 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

33 A pre-acquisition agreement generally provides the terms and conditions under which the acquisition will proceed, the basis on which the board of directors of Targetco will support the offer by Acquireco to the Targetco shareholders, any "lock-up" agreements with major shareholders, and how Targetco will be operated in the intervening period.

2008 CR 15 Footnote-34 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

34 CRA document no. 2005-0157381E5, March 7, 2007.

2008 CR 15 Footnote-35 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

35 At the 1989 Tax Executives Institute meeting with the CRA, the CRA accepted that a covenant to limit dividends to a percentage of retained earnings would not, in and of itself, constitute a violation of the dividend entitlement requirement.

2008 CR 15 Footnote-36 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

36 In such a case, the requirements of regulation 6204(1)(a) " " should not be an issue, since the test of "prescribed share" status must be met "at the time of [the share's] sale or issue."

2008 CR 15 Footnote-37 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

37 See, for example, *Imperial Oil Ltd. v. Canada; Inco Ltd. v. Canada*, 2006 SCC 46; *Placer Dome Canada Ltd. v. Ontario (Minister of Finance)*, 2006 SCC 20; and *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54.

2008 CR 15 Footnote-38 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

38 Canada, Department of Finance, 1994 Budget, Tax Measures: Supplementary Information, February 22, 1994. Along these lines, in CRA document no. 2007-0241931C6, October 5, 2007, the CRA indicated that the objective of the requirements in regulation 6204 " " is to disallow the favourable tax treatment for bonuses disguised as stock options. An example of such a disguised bonus is seen in Janette Pantry, "Paragraph 110(1)(d) " " " —Stock Option Deduction—Unwarranted Application of Prescribed Share Provisions" (2005) vol. 17, no. 1 *Taxation of Executive Compensation and Retirement* 563-66, where it is suggested that the intent was to ensure that the 50 percent deduction would not be available if ordinary salary is replaced with an option to acquire a retractable preferred share where the retraction price was guaranteed to increase over time.

2008 CR 15 Footnote-39 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

39 RSC 1985, c. C-44, as amended.

2008 CR 15 Footnote-40 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

40 Namely, the jurisprudence dealing with the meaning of the term "control" for tax purposes: see *Duha Printers (Western) Ltd. v. The Queen*, 98 DTC 6334 (SCC).

2008 CR 15 Footnote-41 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

41 See, for example, *Nowegijick v. The Queen et al.*, 83 DTC 5041, at 5045 (SCC), in which the Supreme Court of Canada stated: "The words 'in respect of' are, in my opinion, words of the widest possible scope. They import such meanings as 'in relation to,' 'with reference to' or 'in connection with.' The phrase 'in respect of' is probably the widest of any expression intended to convey some connection between two related subject matters."

2008 CR 15 Footnote-42 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

42 As suggested in Gabrielle M.R. Richards, "Recent Transactions," in *Report of Proceedings of the Fifty-Fifth Tax Conference*, 2003 Conference Report (Toronto: Canadian Tax Foundation, 2004), 29:1-25.

2008 CR 15 Footnote-43 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

43 Where the pre-acquisition agreement is not an "agreement in respect of the share" (on the basis discussed above), regulation 6204(1)(a)(iv) " " should not apply. Regulation 6204(1)(b) " " will nevertheless have potential application, because that provision does not rely on an agreement in respect of the share.

2008 CR 15 Footnote-44 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

44 Paragraph 251(5)(b) " " provides that all rights a person may have to acquire shares, even if the rights are only exercisable in the future and are contingent, are deemed to be exercised for the purpose of determining whether the person is related to the corporation pursuant to subsection 251(2) " ".

2008 CR 15 Footnote-45 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

45 Depending on the factual circumstances, the agreement may also result in Acquireco and Targetco dealing at non-arm's length in fact.

2008 CR 15 Footnote-46 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

46 In this regard, regulation 6204(4) " " provides that for the purposes of the specified person definition in regulation 6204(3) " ", the Act is to be read without reference to subsection 256(9) " ", which would otherwise deem the acquisition of control to have occurred at the first moment of the day on which the Targetco shares were acquired by Acquireco.

2008 CR 15 Footnote-47 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

47 This anomaly was the subject of submissions made by the Joint Committee on Taxation of the CBA and the CICA to the Department of Finance on July 29, 2005: Joint Committee on Taxation of the Canadian Bar Association and Canadian Institute of Chartered Accountants, "Re: Issues for Consideration—Next Technical Amendments Bill—2005 Submission," July 29, 2005. The joint committee recommended that the definition of "specified person" should exclude all persons or partnerships who are deemed non-arm's-length only because of a right described in paragraph 251(5)(b) " " or, alternatively, should broaden the reference to "offer" to include all transactions in which the shares of Targetco are acquired or Targetco is merged with Acquireco. While not explicitly mentioned in the submissions, the latter "broadening" should also encompass situations where Targetco is merged with a subsidiary of Acquireco.

2008 CR 15 Footnote-48 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

48 CRA document no. 2005-0151001R3, 2006.

2008 CR 15 Footnote-49 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

49 For further discussion, see Jeffrey Trossman, "Triangular Amalgamations," in *Report of Proceedings of the Fifty-Third Tax Conference*, 2001 Conference Report (Toronto: Canadian Tax Foundation, 2002), 22:1-35.

2008 CR 15 Footnote-50 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

50 Submission made by the Joint Committee on Taxation of the CBA and the CICA to the Department of Finance on July 29, 2005, supra note 47.

2008 CR 15 Footnote-51 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

51 Subsection 186(2) of the Excise Tax Act, RSC 1985, c. E-15, as amended, permits a registered corporation to claim input tax credits relating to property or services acquired relating to its acquisition or proposed acquisition of "all or substantially all" of the issued and outstanding shares of the capital stock of another corporation,

provided that the target corporation is involved exclusively in commercial activities. For a detailed discussion of the CRA's published administrative positions regarding the meaning of "all or substantially all" in this context and the potential application with respect to regulation 6204 " ", see Glen Loutzenhiser, "Prescribed Share Concerns When Employee Stock Options Are Exercised During a Takeover Bid" (2002) vol. 13, no. 9 *Taxation of Executive Compensation and Retirement* 131-35.

2008 CR 15 Footnote-52 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

52 Most provincial securities acts define a takeover bid as an offer to acquire securities that, together with the offeror's securities, would constitute 20 percent or more of the outstanding securities of that class.

2008 CR 15 Footnote-53 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

53 See, for example, *Income Tax Technical News* no. 7, February 21, 1996.

2008 CR 15 Footnote-54 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

54 While the CRA has not publicly considered this issue in the context of a DSU plan, a similar issue arises in respect of deferred salary leave plans governed by regulation 6801(a) " ". One of the requirements of that provision is that the employee must return to work for a period at least equal to his or her leave of absence. In CRA document no. 2003-0003705, March 12, 2003, the CRA dealt with a situation where the employee did not return to work. In those circumstances, the CRA indicated that if at the time the arrangement was made there was no intention to meet this requirement, the SDA rules would apply at that time, but that when an arrangement meets the requirements of regulation 6801(a) at the time it is established but later fails to meet the requirements, it is at that later point that the amount should be included in the employee's income.

2008 CR 15 Footnote-55 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

55 Issues relating to the treatment of stock options on the conversion of an MFT to a corporation are discussed below under the heading "SIFT Conversions: Potential Issues."

2008 CR 15 Footnote-56 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

56 See, for example, CRA document no. 9309555, June 11, 1993, where the CRA stated that the substitution of the phantom units for the stock options would be considered a disposition of property and the value of the units would be included in the employees' income to the extent that any amount was not included in the income in the previous years. The CRA stated that the amount included in the employee's income on the disposition would be considered as an amount paid by the employee to acquire the option for the purposes of subsection 7(1) " " and paragraph 110(1)(d) " ".

2008 CR 15 Footnote-57 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

57 See, for example, CRA document nos. 2004-0056921R3, 2004; 2001-0067027, February 16, 2001; and 2003-0043361R3, 2004. Similarly, the CRA has accepted that the termination of a SAR in exchange for the issuance of shares should be governed by section 7 " ". See, for example, CRA document no. 2000-0016875, August 10, 2000.

2008 CR 15 Footnote-58 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

58 CRA document no. 2006-0178881E5, January 16, 2007, on the basis that the conversion would permit a payout of the DSUs prior to termination of employment in contravention of the requirements of regulation 6801(d) " ".

2008 CR 15 Footnote-59 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

59 In many respects, this condition tracks the CRA's views on constructive receipt of employment income. In the CRA's view, constructive receipt occurs at a time when the employee acquires an unrestricted right to a payment and, accordingly, an employee is entitled to defer employment compensation, provided that he or she does so before becoming entitled to the amount being deferred. See, for example, paragraph 11 of *Interpretation Bulletin* IT-502 " ", "Employee Benefit Plans and Employee Trusts," March 28, 1985.

2008 CR 15 Footnote-60 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

60 See, for example, CRA document nos. 9932063, 1999; 2000-0043243, 2000; and 2004-0088601R3, 2004.

2008 CR 15 Footnote-61 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

61 See, for example, CRA document nos. 2002-0169103, 2003 (as amended by 2003-0025681, 2003 and 2003-0030761, 2003); 2003-0033723, 2003 (as amended by 2003-0050031, 2003); and 2002-0123153, 2002.

2008 CR 15 Footnote-62 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

62 The term "Finance" is used to refer, collectively, to the Canadian minister of finance and the Department of Finance.

2008 CR 15 Footnote-63 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

63 The SIFT conversion proposals are currently contained in Bill C-10, An Act To Implement Certain Provisions of the Budget Tabled in Parliament on January 27, 2009 and Related Fiscal Measures, first reading February 6, 2009. References to "proposed" sections of the Act are references to the provisions of Bill C-10.

2008 CR 15 Footnote-64 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

64 See, for example, F. Brenton Perry, "Income Trusts: Reorganizations and Planning for 2011," in this volume.

2008 CR 15 Footnote-65 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

65 See, for example, Lorne Shillinger, "Developments in the Taxation of Real Estate Investments," in *Report of Proceedings of the Fifty-Ninth Tax Conference*, 2007 Conference Report (Toronto: Canadian Tax Foundation, 2008), 13:1-70; Mitchell Sherman and Jarrett Freeman, "The Gift of SIFT," ibid., 14:1-37; Scott Bodie and Joanne Vandale, "SIFTing Through the Wreckage: The Rise and Demise of Canadian Income Trusts," in *2007 Prairie Provinces Tax Conference*, supra note 1, tab 9; and Thomas Bauer, "The New Income Trust Conversion Proposals" (2008) vol. 12, no. 1 *Business Vehicles* 610-17.

2008 CR 15 Footnote-66 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

66 The unit exchange alternative can be utilized where New Pubco is an existing subsidiary of MFT, a new corporation formed for the purpose of the conversion transaction, or a previously existing arm's-length corporation (that is, in the case of a conversion transaction which is combined with an acquisition), whereas the distribution alternative is generally available only where New Pubco is an existing or newly formed subsidiary of the MFT.

2008 CR 15 Footnote-67 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

67 The exchange of MFT options for options to acquire shares of New Pubco is not the only way to deal with the issue. Holders of MFT options could also be forced to exercise or surrender such options prior to the conversion transaction so that the options are terminated prior to, or as part of, the plan of arrangement. Such an approach might be considered when existing options are out of the money. See, for example, the conversion of True Energy Trust into True Energy Inc. In True Energy Trust, "Information Circular and Proxy Statement," March 2, 2007 (online: http://www.sedar.com/), the statement was made that pursuant to the terms of the relevant plans, vesting of all incentive rights was accelerated, the rights became exercisable prior to the completion of the arrangement, and any rights not exercised were terminated immediately prior to the effective time for no consideration. See also Bonterra Energy Income Trust, "Joint Information Circular," September 17, 2008 (online: http://www.sedar.com/), relating to a transaction where unexercised trust unit options were cancelled pursuant to the plan of arrangement.

2008 CR 15 Footnote-68 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

68 See *Amirault v. MNR*, 90 DTC 1330 (TCC) and *Wiebe et al. v. The Queen*, 87 DTC 5068 (FCA), which indicate that a fundamental change to a stock option that goes to the root of the contract constitutes a disposition of the old contract and the entry into a new contract. In a conversion transaction of the sort under consideration, one could argue that the change in the security subject to the option from an MFT unit to a share, is not, by itself, sufficient to constitute a disposition, particularly when all of the other terms and conditions of the option remain unchanged, on the basis that the option holder remains entitled to acquire an equity interest in his or her employer. That being said, there is also a compelling argument that the type and kind of security subject to the option is a fundamental aspect of any option.

2008 CR 15 Footnote-69 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

69 But for the potential applicability of the relieving rule in subsection 7(1.4) " ", an exchange of options might be expected to be treated as a disposition by the employee of the MFT option, triggering an employment income inclusion pursuant to paragraph 7(1)(b) " " equal to the value of the consideration (that is, the New Pubco options) received by the employee. In the case of an option exchange where the proceeds received are non-monetary, it is possible that the employees can be considered to have received the FMV of the New Pubco options issued to them in consideration for the MFT options. This is the position taken by the CRA in, for example, CRA document no. 9731165, January 21, 1998. It might, however, be possible to argue that some protection is afforded by paragraph 7(3)(a) " ", which provides, in essence, that where an employee receives a right governed by section 7 " " (that is, the New Pubco option), the employee is not to be taxed under any other provision of the Act. In a conversion transaction, the argument would be that because the New Pubco options represent an agreement by New Pubco to issue shares from treasury to the former holders of MFT options, paragraph 7(3)(a) should govern the timing of the receipt and the income inclusion to the holders, at least when such holders are also employed by New Pubco following the conversion transaction. The argument that paragraph 7(3)(a) takes precedence over other provisions of the Act has also been confirmed in *MNR v. Chrysler Canada Ltd. et al.*, 92 DTC 6346 (FCTD).

2008 CR 15 Footnote-70 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

70 Paragraph 7(1.4)(d) " ".

2008 CR 15 Footnote-71 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

71 Paragraph 7(1.4)(e) " ".

2008 CR 15 Footnote-72 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

72 For the conditions to be satisfied when there has been an option exchange to which subsection 7(1.4) " " applied, see subparagraph 110(1)(d)(iii) " ".

2008 CR 15 Footnote-73 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

73 See the prescribed conditions in regulation 4801(b) " ", which requires that there be at least 150 unitholders, each of whom holds not less than one "block of units" of the class having an aggregate fair market value of not less than $500.

2008 CR 15 Footnote-74 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

74 Subparagraph 7(1.4)(b)(ii) " ".

2008 CR 15 Footnote-75 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

75 Proposed subparagraph 7(1.4)(b)(vi) " " in Bill C-10, supra note 63.

2008 CR 15 Footnote-76 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

76 The policy reasons behind the restrictive definition of non-arm's-length in this context are not—to us at least—entirely clear, although it is assumed that the purpose was to ensure that there was a suitable connection between a corporate employer and the MFT in respect of which options are being issued. In addition, at the time the provision was introduced, the Act did not contain any clear rules for delineating non-arm's-length relationships for trusts. In any event, the provision is clearly premised on a "traditional" MFT, where the trust controls, directly or indirectly, an operating corporation that employs all of the employees.

2008 CR 15 Footnote-77 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

77 In other contexts, the limitations of subsection 7(1.11) " " have been brought to Finance's attention. In a comfort letter issued December 4, 2006, the Department of Finance agreed to recommend that the scope of subsection 7(1.11) be expanded to include a corporation and an MFT where the corporation owns securities that would give it more than 50 percent of the votes that could be cast in all circumstances at a meeting of unitholders of the trust. The comfort letter, which predates the SIFT conversion proposals, appears to be designed to permit employees of an MFT (or a subsidiary corporation or limited partnership) to be granted stock options to acquire shares of a corporation in a situation where the corporation spins off part of its business into a trust and sponsors the trust by retaining voting control of the trust, either in the form of trust units or exchangeable partnership

units. Given the changes in the SIFT tax regime, however, it is uncertain whether this comfort letter will be acted upon. If implemented, the amendment could be of assistance in the context of a conversion transaction, since New Pubco would have voting control of MFT and thus, pursuant to the comfort letter, would be deemed to deal at non-arm's length with MFT for the purposes of section 7 " ".

2008 CR 15 Footnote-78 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

78 Where New Pubco is a new corporation formed for the purposes of the conversion, it should nevertheless be possible to structure the transaction so that this test is met by having the new corporation issue one share to the MFT on its incorporation.

2008 CR 15 Footnote-79 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

79 See, for example, the conversion of High Artic Energy Services Trust into High Arctic Energy Services Inc., described in High Arctic Energy Services Trust, "Information Circular and Proxy Statement," May 29, 2007 (online: http://www.sedar.com/) and the conversion of Trinidad Energy Services Income Trust into Trinidad Drilling Ltd., described in Trinidad Energy Services Income Trust, "Information Circular and Proxy Statement," January 30, 2008 (online: http://www.sedar.com/). See also the conversion of BFI Canada Income Fund into BFI Canada Ltd. Although the BFI Canada Income Fund, "Management Information Circular," August 26, 2008 (online: http://www.sedar.com/), was released after the announcement of the SIFT conversion proposals, the transaction appears to have been structured so that it could proceed even if the SIFT conversion proposals were not enacted.

2008 CR 15 Footnote-80 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

80 See the definition of "SIFT trust" in subsection 122.1(1) " ".

2008 CR 15 Footnote-81 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

81 See the definition of "SIFT trust wind-up event" in subsection 248(1) " ".

2008 CR 15 Footnote-82 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

82 See, for example, the conversion of Newalta Income Fund into Newalta Inc., described in Newalta Income Fund, "Information Circular and Proxy Statement," November 12, 2008 (online: http://www.sedar.com/).

2008 CR 15 Footnote-83 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

83 Practically speaking, this may not be an issue, since the value of New Pubco shares may be less than the MFT trust units if the conversion takes place prior to 2011 (or later, if an extension of the grandfathering period is implemented), since such a conversion will generally result in the immediate imposition of corporate-level tax, whereas retention of the MFT structure would, in the case of a grandfathered MFT, defer the imposition of corporate tax until 2011.

2008 CR 15 Footnote-84 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

84 Some MFT option plans reduced the exercise price based solely on the quantum of distributions in a calendar year (for example, where the distributions exceeded a specified percentage of the original exercise price of the option).

2008 CR 15 Footnote-85 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

85 Where the trading price of trust units decreases as a result of distributions, some MFTs have also tried to accomplish the same objective by structuring the option price reduction as an option exchange pursuant to subsection 7(1.4) " " or a repricing pursuant to proposed subsections 110(1.7) " " and (1.8) " " (discussed below under "Repricing Strategies"). See, for example, CRA document no. 2004-0093241E5, October 29, 2004.

2008 CR 15 Footnote-86 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

86 The fact that the exercise price of the trust unit option may be determined by formula should not affect the availability of the paragraph 110(1)(d) " " deduction. Clause 110(1)(d)(ii)(A) " " requires that the "amount payable" by the option holder to acquire the MFT units be not less than the FMV of the MFT units at the time the option was granted. Although not in the context of MFTs, the CRA has expressed its views on whether this FMV test is satisfied when the exercise price of an option is computed by reference to a formula, such that the

exercise price could, depending on the time of exercise, be less than, equal to, or greater than the FMV of the underlying security at the time the option was granted. In such circumstances, the CRA has confirmed that the deduction under paragraph 110(1)(d) is available when the actual exercise price of the option is equal to or greater than the FMV of the security at the time the option was granted. The mere possibility that the employer's securities could be purchased for less than their FMV at the time the option was granted does not, in the CRA's view, cause a denial of the deduction, so long as the price ultimately paid is equal to or greater than such FMV. In part, this is because the determination of whether or not the paragraph 110(1)(d) requirements are met is normally made at the time that the option is exercised and the underlying security is acquired. On these points, see, for example, CRA document nos. 91M11295, November 1, 1991; 9619933, 1996; 9321835, August 26, 1993; 900754, August 20, 1990; and 9924623, November 1, 1999.

2008 CR 15 Footnote-87 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

87 In CRA document no. 2001-0076493, 2001, the CRA stated as follows:

> Since a Participant will be allowed to exercise his or her options at the discounted price or at the Market Price on the date the options were granted, we are of the view that paragraph 110(1)(d) " " will not apply where paragraph 7(1)(b) " " applies to a Participant that disposes of his or her options. Because of the two prices that can be paid under the option, clause 110(1)(d)(ii)(A) " " of the Act will not be satisfied by the Participant.

The statement is troublesome because it suggests that where a trust unit option with an adjustable exercise price has cashed out, the paragraph 110(1)(d) " " deduction will not be available, even if the original FMV exercise price is used to compute the amount of the cash payment. We are unaware of anything recent on this topic from the CRA, but the result does not appear to follow logically.

2008 CR 15 Footnote-88 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

88 The other related issue is that for the option holder to be able to claim the paragraph 110(1)(d) " " deduction on the exercise/surrender of the New Pubco option, clause 110(1)(d)(iii)(A) " " requires the "amount payable" under the New Pubco option be not less than the amount that was included in the "amount determined under subparagraph 7(1.4)(c)(ii) " "." The use of the word "determined" (as compared, for example, with "determinable") implies that there must be a determination of the "amount payable" under subsection 7(1.4) " " at the time of the option exchange.

2008 CR 15 Footnote-89 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

89 On the reasoning in *Amirault*, supra note 68, such an amendment should not constitute a disposition of the option, because it goes only to the timing of the assessment of the exercise price of the option.

2008 CR 15 Footnote-90 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

90 A similar approach was used to deal with trust unit options with an adjustable exercise feature in the conversion of Trinidad Energy Services Income Trust into Trinidad Drilling Ltd., described in the Trinidad Energy Services Income Trust, "Information Circular and Proxy Statement," supra note 79, although it was framed as an election with respect to the exercise price of the New Pubco options. There, option holders who failed to make an election were deemed to have elected the original exercise price pursuant to the plan of arrangement.

2008 CR 15 Footnote-91 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

91 A similar approach appears to have been used to deal with trust unit options with an adjustable exercise feature in the conversion of High Artic Energy Services Trust into High Arctic Energy Services Inc., described in High Arctic Energy Services Trust, "Information Circular and Proxy Statement," supra note 79. There, the plan of arrangement provided that aside from the substitution of New Pubco shares for trust units, the New Pubco options would have the same terms and conditions as the old MFT options, "including, without limitation, the same 'in-the-money' amount, if any." It is not clear, however, whether there were any in-the-money options at the time of the arrangement.

2008 CR 15 Footnote-92 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

92 Paragraph 7(1.5)(a) " ".

2008 CR 15 Footnote-93 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

93 Paragraph 7(1.5)(b) " ".

2008 CR 15 Footnote-94 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

94 Subparagraph 7(1.5)(b)(ii) " ".

2008 CR 15 Footnote-95 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

95 Paragraph 7(1.5)(c) " ".

2008 CR 15 Footnote-96 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

96 Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, "Submissions to the Department of Finance re Guidance on 'Normal Growth' for Income Trusts and Other Flow-Through Entities," February 21, 2007, pointed out the limitations of subsection 7(1.11) " ", in the context of both subsections 7(1.4) " " and 7(1.5) " ", although such concerns appear to have been addressed only in subsection 7(1.4).

2008 CR 15 Footnote-97 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

97 Supra note 68.

2008 CR 15 Footnote-98 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

98 The CRA accepts such an approach, confirming, for example, in CRA document no. 9724275, October 7, 1997, that it will apply the decision in *Amirault* such that the repricing of an option will not result in a disposition of that option.

2008 CR 15 Footnote-99 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

99 From a public market 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 option in the same manner. Repricing requires TSX approval in advance, and shareholder approval is required where option holders include insiders. See, on this point, *TSX Staff Notice* 2005-0001, March 21, 2005. A repricing that is accomplished by way of option exchange may, however, raise adverse accounting issues, not to mention the administrative burden of cancelling and reissuing options that are, in essence, the same options as those originally granted except for the reduced exercise price.

2008 CR 15 Footnote-100 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

100 Correspondingly, the option holder will also lose the ability to elect to defer the taxation of the stock option benefit upon exercise pursuant to subsections 7(8) " " through 7(10) " ", since the condition in paragraph 7(9)(b) " " will not be satisfied.

2008 CR 15 Footnote-101 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

101 A corresponding proposed amendment permits late-filed deferral elections under subsections 7(8) " " through 7(10) " ".

2008 CR 15 Footnote-102 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

102 In CRA document no. 2007-0247611R3, 2008, the CRA provided a non-binding opinion on the reliance of the proposed amendments in the context of a repricing that took place in the course of a butterfly transaction.

2008 CR 15 Footnote-103 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

103 CRA document no. 2001-0105023, January 8, 2002, and CRA document no. 2001-0096795, March 6, 2002.

2008 CR 15 Footnote-104 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

104 See paragraph (c) of the definition of "qualified investment" in subsection 207.01(1) " " and regulation 4900(1)(e) " ".

2008 CR 15 Footnote-105 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

105 See paragraph (c) of the definition of "prohibited investment" in subsection 207.01(1) " " and the definition of

"significant interest" in subsection 207.01(4) " ".

2008 CR 15 Footnote-106 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

106 See, for example, CRA document no. 9621975, July 5, 1996. However, given the potentially significant tax benefits, it is possible that the CRA could insist on a Black-Scholes-type value.

2008 CR 15 Footnote-107 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

107 It seems clear that this use of TFSAs was not in the mind of Finance, and it remains to be seen whether the legislation will be amended to prohibit this sort of transfer. Query whether the proposed extension of the definition of "advantage" in subparagraph 207.01(b)(i) " " could be used by the CRA to challenge this sort of arrangement, on the basis that an arm's-length person would not have contributed a stock option to a TFSA for nil consideration.

2008 CR 15 Footnote-108 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

108 Regulation 6801(d) " " provides that a plan will be disqualified from the exemption from the salary deferral arrangement rules if "by reason of the arrangement or a series of transactions that includes the arrangement, the employee or a person with whom the employee does not deal at arm's length is entitled, either immediately or in the future, either absolutely or contingently, to receive or obtain any amount or benefit granted or to be granted for the purpose of reducing the impact, in whole or in part, of any reduction in the fair market value of the shares of the corporation or a corporation related thereto." As an exception to this rule, the CRA permits the grant of additional DSUs to compensate the holder for loss in value solely attributable to an extraordinary transaction, such as a spinoff of assets or an extraordinary distribution.

2008 CR 15 Footnote-109 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

109 *Shoppers Drug Mart Limited v. The Queen*, 2008 DTC 2043 (TCC).

2008 CR 15 Footnote-110 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

110 The in-the-money value is generally computed as the difference between the FMV of the target company shares that could be acquired under the option less the exercise price that would have to be paid.

2008 CR 15 Footnote-111 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

111 The opportunity to surrender the stock options for cash is generally structured so that it is at the employee's election, in order to ensure that the options continue to be governed by section 7 " " and that the employee is able to benefit from the capital-gains-like treatment afforded by paragraph 110(1)(d) " ".

2008 CR 15 Footnote-112 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

112 It is assumed for the purposes of this paper that the conditions in section 67 " " and paragraph 18(1)(a) " " are met—namely, that the expenses are employment expenses incurred to earn income from a business.

2008 CR 15 Footnote-113 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

113 *Symes v. The Queen et al.*, 94 DTC 6001 (SCC).

2008 CR 15 Footnote-114 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

114 *The Queen v. Kaiser Petroleum Ltd.*, 90 DTC 6603 (FCA).

2008 CR 15 Footnote-115 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

115 CRA document no. 2000-0048355, November 14, 2000.

2008 CR 15 Footnote-116 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

116 *Canada Forgings Ltd. v. The Queen*, 83 DTC 5110 (FCTD).

2008 CR 15 Footnote-117 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

117 Supra note 114, at 6606.

2008 CR 15 Footnote-118 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

118 Indeed, the CRA has taken this position with respect to other transaction costs with varying degrees of success. See, for example, CRA document no. 2006-0195981C6, October 6, 2006.

2008 CR 15 Footnote-119 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

[119] Supra note 109, at paragraph 6.

2008 CR 15 Footnote-120 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

[120] Ibid., at paragraph 8.

2008 CR 15 Footnote-121 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

[121] Ibid., at paragraph 14, which states: "On December 14, 1999, Imasco accelerated the vesting of the options."

2008 CR 15 Footnote-122 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

[122] Ibid., at paragraph 13, which summarizes section 5.8 " " of the "Support Agreement" that was a fundamental part of the acquisition of Imasco. The second paragraph of that section states: "BAT and Bidco acknowledge that the completion of the Going Private Transaction will constitute a 'Fundamental Change' under Imasco's incentive and other employment related arrangements resulting in the acceleration of the vesting, funding and/or payout of rights under such arrangements."

2008 CR 15 Footnote-123 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

[123] Ibid., at paragraph 16, which states that in January of 2000, employees of Shoppers Drug Mart exercised 62,800 options to receive Imasco shares and on January 28, 2000 Shoppers Drug Mart employees holding 2,190,380 options elected to surrender their options for cash.

2008 CR 15 Footnote-124 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

[124] Clause 4.2 of the sale agreement of July 11, 1978 between Ashland US and Kaiser Resources Ltd., as described in *Kaiser*, supra note 114, at 6604.

2008 CR 15 Footnote-125 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

[125] Supra note 109, at paragraph 31.

2008 CR 15 Footnote-126 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

[126] Ibid., at paragraphs 28-29.

2008 CR 15 Footnote-127 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

[127] Ibid., at paragraphs 30 and 32-33 (emphasis added).

2008 CR 15 Footnote-128 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

[128] Ibid., at paragraphs 22-23.

2008 CR 15 Footnote-129 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

[129] *Imperial Tobacco Canada Limited v. The Queen*, docket no. 2008-402(IT)G (TCC).

2008 CR 15 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

AUTHOR INFORMATION

Anu Nijhawan. Bennett Jones LLP, Calgary. BSc (1996) Queen's University; LLB (1999) University of British Columbia. Contributor to tax and industry publications; presenter at tax seminars and conferences on a variety of tax-planning topics.

Steven Sieker. Bennett Jones LLP, Calgary. BA (1991) University of Alberta; LLB (1995) Dalhousie University. Frequent writer and presenter on tax-related matters. Former part-time tax lecturer, Hong Kong University and City University of Hong Kong.

2008 CR 15 Equity-Based Employee Compensation (Nijhawan, A. & S. Sieker)

BIBLIOGRAPHY INFORMATION

Anu Nijhawan and Steven Sieker, "Topical Issues in Equity-Based Employee Compensation," *Report of Proceedings of Sixtieth Tax Conference*, 2008 Tax Conference (Toronto: Canadian Tax Foundation, 2009), 15:1-36.