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INCENTIVES AND BENEFITS

Transfer of Employee Stock Options to Tax-Free Savings Accounts

Anu Nijhawan

Nandini Nandini, *Bennett Jones LLP*

Tax-free savings accounts ("TFSAs") were introduced in the 2008 Federal Budget and came into effect on January 1, 2009. Lauded by the Department of Finance as the "single most important personal savings vehicle since the introduction of the RRSP," the TFSA rules provide various planning opportunities. This article discusses one of those opportunities – the contribution of employee stock options to a TFSA.[1]

The rules surrounding and potential impact of TFSAs have been discussed in other articles in this journal.[2] The basic concept is that Canadian residents age 18 and older are permitted to contribute up to $5,000 annually (indexed to inflation) into a TFSA with unused room being carried forward. Contributions to a TFSA are not tax-deductible but all income (including capital gains) within a TFSA accrues on a tax-free basis. Withdrawals from a TFSA are not taxable (unlike an RRSP) and funds withdrawn from a TFSA create contribution room for future savings. With withdrawals of contributions and accrued income being tax-free, there is a clear incentive for taxpayers to contribute "high-yield" property to a TFSA so as to maximize the overall tax advantage. As described below, the employee stock option may be one such property.

Can a Stock Option Be Contributed to a TFSA?

In general terms, a property (including, an employee stock option) can be contributed to a TFSA provided it is a "qualified investment" and is not a "prohibited investment." Pursuant to the definition of "qualified investment" in subsection 207.01(1) of the Income Tax Act[3] and the investments prescribed in Regulation 4900(1), an option that gives the holder a right to acquire a share which is listed on a designated stock exchange is a qualified investment for a TFSA. As a consequence, an employee stock option which entitles the employee to acquire a share of a public corporation should constitute a qualified investment for a TFSA.

An employee stock option will be a "prohibited investment" for a TFSA where the holder of the TFSA holds (together with non-arm's length persons) 10% or more of the shares of any class of shares of the issuing corporation[4] or where the holder of the TFSA does not deal at arm's length with the issuing corporation. One would not expect these prohibitions to be at play in the case of most employee optionholders, although they should be kept in mind.

Thus, from a tax perspective, it will generally be possible for an optionholder to contribute an employee stock option to his or her TFSA. It is also necessary to consider the securities/public markets impact of such a contribution, particularly in the case of a stock option plan which prohibits transfers of such options.[5]

The one item to consider is subsection 207.05(2), which provides for a 100% penalty tax on the fair market value of any benefit in respect to an "advantage." Pursuant to the amendments implemented by the recently enacted Bill C-10 to paragraph 207.01(1)(*b*), there will be considered to be an "advantage" where there is "an increase in the total fair market value of the property held in connection with the TFSA if it is reasonable to consider, having regard to all the circumstances, that the increase is attributable, directly or indirectly, to ... a transaction or event or a series of transactions or events that ... would not have occurred in an open market in which parties deal with each other at arm's length and act prudently, knowledgeably and willingly" and had one of its main purposes to enable a person to benefit from the exemption from tax afforded to a TFSA. Under one reading of this provision, it could apply where a stock option was contributed to a TFSA in circumstances where the transaction would not have taken place between arm's length parties and the intent was to bolster the value of the property of the TFSA. Whether this was the intent of the provision is not clear, but the issue should be considered in detail prior to any contribution of stock options to a TFSA.

Value of Contribution Where a Stock Option Is Contributed to a TFSA

Having concluded that it may be possible to contribute an employee stock option to a TFSA, the critical question is what the "value" of such a contribution will be, having regard to the annual contribution limit of $5,000.

Neither the Canada Revenue Agency ("CRA") nor the Department of Finance have provided any definitive guidance on this point. In the mid-1990s, the CRA considered the same issue where employee stock options are transferred to RRSPs and seemed to accept that the value of the option was equal to its in-the-money amount (i.e., the amount by which the value of the underlying securities exceeds the exercise price payable under the option).[6] The CRA has also considered the valuation issue where stock options are granted to a consultant[7] and has stated that the value of an option is the greater of the trading value of the rights received and in-the-money amount of the option.[8]

Thus, where an employee is granted an option by a public corporation at an exercise price equal to the underlying value of the shares (which is mandated, in any event, by the TSX rules), there is a strong argument that the option has no value at that time. On that basis, if the option was contributed to the TFSA at the same time, the contribution should, arguably, be nil. Such a result could be said to give rise to an anomaly – clearly, the option has some potential value (even if difficult to quantify) – otherwise it would not serve to incentivize the employee at the time it was granted. In such a circumstance, it is possible that the CRA could adopt another valuation method (for example, a Black-Scholes method)[9] for stock options. That being said, given the implications in a wide variety of circumstances, it would be difficult for the CRA to do so in the absence of statutory amendments.

The issue is even more interesting in the case of an "underwater" employee stock option (i.e., an option where the exercise price is greater than the current trading price of the shares that can be acquired under the option). While there is no CRA commentary on valuing such an option, it would seem to follow that such an option has nil value and could, accordingly, be contributed to a TFSA without utilizing any contribution room. This issue may be of increasing importance, given that many public company options granted in 2007 and early 2008 may well be underwater and, given shareholder reluctance to implement re-pricing strategies, contributing underwater options to a TFSA may be one other way of permitting an employee to obtain some "benefit" from the options.

Where an option has "nil" value, it would then be possible to contribute an unlimited number of options to a TFSA and, in effect, entirely circumvent the contribution limits. Even more notable, as the option grows in value, the option could be exercised by the TFSA and the after-tax value could continue to earn income on a tax-free basis.

Given the "advantage" rule described above, it will be important to show that the contribution of the stock option to a TFSA would have been made between arm's length persons. To this extent, a Black-Scholes or other valuation technique might be preferable to help establish arm's length terms. On first blush, it would appear easier to argue that an arm's length person would have entered into a similar transaction if some more than nominal value is placed on the stock option.

Section 7 Taxation

Where an employee chooses to contribute a stock option to a TFSA, it is important to note that the ultimate tax payable when the option is exercised or surrendered is not avoided. In particular, pursuant to the rules in paragraph 7(1)(*c*), the optionholder would not incur any tax liability at the time of the contribution to the TFSA but would be taxable on the section 7 benefit (i.e., the value of the shares acquired less the exercise price) at the future time the TFSA exercised or surrendered the option.[10] Thus, the benefit of contributing stock options to a TFSA is not to avoid paying tax on the option benefit itself, but rather, as described below, to expand the amount that can potentially grow tax-free in the TFSA.[11]

The Overall Effect

The overall impact of the foregoing is best illustrated by an example.

Assume that an employee is granted 10,000 options with an exercise price of $1 each and contributes those options to his or her TFSA at a time when the underlying securities are trading at $1. In those circumstances, based on the CRA's current administrative position, the value of the contribution made to the TFSA is arguably nil. Further assume that, as market conditions improve, the underlying securities trade at $5. The options are then exercised (if the TFSA has sufficient funds to pay the exercise price) and the acquired shares are sold by the TFSA for cash or the options are surrendered for cash (if permitted by the terms of the stock option), giving rise to the employee realizing a taxable employment benefit of $20,000 (i.e., $40,000 section 7 benefit less the 50% paragraph 110(1)(*d*) deduction) and the TFSA would have cash proceeds of $40,000. Assuming a tax rate of 40%, the employee could then withdraw $8,000 from the TFSA (tax-free) to pay the tax liability but the TFSA would continue to accumulate tax-free income on the remaining $32,000. Even better, the employee would withdraw that $32,000, use it to purchase a car/boat/vacation property and then, in the future, re-contribute the entire $40,000. In effect then, the employee has permanently created $40,000 of contribution room in the TFSA.

Given the recent statutory amendments to the definition of "advantage," it appears that the CRA and Department of Finance will accept such a result without challenge, and a higher valuation should likely be used to establish arm's length terms.

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[1] Some of the analysis in this article is based on portions of an article written by the author soon to be published by the Canadian Tax Foundation and entitled, "Topical Issues in Equity-Based Compensation."

[2] See, for example, Ross Gascho, "Tax-Free Savings Accounts and Liberalization of the Withdrawal Rules from Life Income Funds" (2007) 19 *Taxation of Executive Compensation and Retirement* 875 and Jason Eatock, "Saving for Retirement and the Tax-Free Savings Account" (2008) 19 *Taxation of Executive Compensation and Retirement* 987.

[3] R.S.C. 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the "Act." Unless otherwise stated, statutory references in this article are to the Act.

[4] See paragraph (*b*) of the definition of "prohibited investment" in subsection 207.01(1), paragraph 207.01(4)(*b*), and the definition of "specified shareholder" in subsection 248(1).

[5] The TSX rules permit transfers of employee stock options to "permitted assigns," which include an RRSP or RRIF of which the optionholder or his or her spouse is the annuitant. Query whether the same reasoning would apply to permit transfers of employee stock options to a TFSA.

[6]See, for example, CRA *Document* 9503445 (April 28, 1995) and *Document* 9621975 (July 5, 1996). This also seems to be the position taken by the CRA in respect of employee stock options contributed to a TFSA during informal discussions with advisors during TFSA outreach sessions.

[7] In such circumstances, section 7 does not apply and the issue is the amount of the income inclusion arising to the consultant on the option grant.

[8] See, for example, CRA *Document* 2002-0151247 (July 15, 2002), *Document* 1999-0013915 (May 3, 2000) and *Document* 2000-0006395 (March 10, 2000). See, also, *Interpretation Bulletin* IT-96R6, paragraph 3, providing for the same result in the context of the value of an option which constitutes a shareholder benefit pursuant to paragraph 15(1)(*c*).

[9] For an in-depth discussion of various valuation issues, including the limited case law on point, see A. McNaughton and A. Mawani, "Contributions of Employee Stock Options to RRSPs and TFSAs: Valuation Issues and Policy Anomalies" (2008) 56(4) *Canadian Tax Journal* 893.

[10] So long as the relevant criteria are satisfied, the paragraph 110(1)(*d*) 50% deduction should also be available, notwithstanding that it was the TFSA and not the optionholder who exercised or surrendered the option. The CRA has confirmed this point where it is a RRSP that exercises the option – see, for example, CRA *Document* 9503445 (April 28, 1995).

[11] It has been possible to contribute employee stock options to RRSPs for years but this course of action is rarely followed because the section 7 stock option benefit was effectively taxed twice – once pursuant to paragraph 7(1)(*c*) when the option was exercised and secondly when the withdrawal was made from the RRSP. In contrast, there is no double tax when a stock option is contributed to a TFSA since any future withdrawal from the TFSA is tax-free.

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