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September 25th, 1956.

Personal and Confidential

Air Marshal W. A. Curtis,
77 Dawlish Avenue,
Toronto, Ontario.

Dear Wilf:

When we were driving to the airport in Montreal last week, you spoke to me about the taxability of any benefit that you might derive from your option on shares of A. V. Roe Canada Limited. I explained the position to you and said I would write a note confirming what I told you.

Briefly, the position is that no tax arises by reason merely of the granting to you of the option. The problem arises when shares are acquired pursuant to the option and the measure of the benefit that falls to be taxed is the difference between the option price ($12.50) and the value of the shares when they are acquired. Any such benefit received by an employee is deemed to have been received by him by virtue of his employment in the taxation year in which he acquired the shares.

If no special provision for taxing these benefits were contained in the Income Tax Act, they would, like any other benefit or bonus received in the course of employment, be taxable as additional income and at the employee's top rate.

Section 85A of the Income Tax Act provides, however, that an employee who receives such a benefit shall, if he so elects,

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pay as tax on the benefit, in lieu of the amount that would otherwise be payable, a special tax under a very favourable formula. This formula reduced to its simplest terms provides for tax on the benefit at the average rate of tax paid by the employee during the previous three years, after reducing the rate by 20 percentage points. For example, if the employee took up his option in 1956, he would add up the amounts payable by way of income tax on his income for 1953, 1954 and 1955 if certain deductions (the most important of which would probably be the dividend tax credit) were not taken. He would then add up his total income for those three years and calculate the ratio of the total tax as aforesaid to the total income. If there were, let us say, $7,000 tax calculated as aforesaid in each of those three years (a total of $21,000) and the employee had received income of $28,000 in each of those three years (a total of $84,000) the average rate of tax for those years would have been 25 per cent. Reduced by the 20 percentage points, the tax payable on the benefit if the shares were taken up in 1956 would be 5 per cent of the benefit. If the shares were taken up in 1957, the same calculation would be made with respect to the taxation years 1954, 1955 and 1956 - and so on. If the employee's income is rising, the formula produces a higher special rate of tax and if it is likely to decrease, it will produce a lower special rate of tax.

The other variable in the computation is, of course, the value of the benefit itself. If the shares covered by the option may be expected to rise steadily, the amount of the benefit which falls to be taxed will, of course, increase each year that exercise of the option is deferred. Against this must be measured the alternative liability which must be incurred if the employee has to borrow the money to take up the shares and then hold them for a number of years to realize a higher price, during which period the vagaries of the stock market might leave him holding something (for a period at least) worth less than his liability for borrowed funds.

In your particular case, assuming that the figures I have used by way of illustration are in the neighbourhood of your own figures and if during the ten-year period of the option you might be considering retirement and consequent lower income so that the future tax on your benefit would be no higher than 5 per cent and might become less or even zero, I think you would be far better off to sit back and delay exercise of your option till sometime in the future without any liability for borrowed money.

I don't know at this time any more than you do what the offering price of the shares will be nor how the market will accept them, but purely by way of illustration let us suppose that the shares, when listed on the Exchange and subject to a regular dividend policy, are worth $16.50. If you exercised your option at that time, your benefit would be 5,000 times $4 which is $20,000. On the basis of the hypothetical figures used above, the special tax on this would be 5 per cent or $1,000. Let us suppose again, purely for purposes of illustration, that the value of the shares rose on the market in 1958 to $20.50 and that you exercised your option in 1958. The value of the benefit which would then be taxed would be 5,000 times $8 or $40,000. Assuming that the formula produced the same special tax on the basis of your income for 1955, 1956 and 1957 as it did for 1953, 1954 and 1955, that is, 5 per cent, the tax in 1958 would be $2,000. In other words, making the most favourable assumptions, the tax would only be $1,000 more and you would not have been subject to a liability for borrowed money in the meantime.

I am particularly mindful of the fact that things sometimes go the other way and if I were in your shoes, I would rather pay a greater tax in the future than run the risk of borrowing money to take up the shares today which, due to circumstances now unforeseeable, might become worth less than you had to borrow to pay for them, with some bank urging repayment at a time when you might be greatly embarrassed.

The only other risk in following this course is that Parliament might change the law to your disadvantage at some time in the future. You are as good a judge of this as I am, but if I were in your place I would take a chance on this.

I hope I have clarified the matter for you and can only add that those who may already have exercised options did so in entirely different circumstances, both as to timing and as to rates of tax applicable which meant in their case that it was worth taking the extra risks.

I should be glad to discuss the whole matter with you further at your convenience.

Yours truly,

John

JSDT*cec