From the Desk of

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The following comments in connection with Employees Stock Option Plans have been copied from an article in the September 1956 Canadian Chartered Accountant on the subject of Executive Compensation:-

Stock Options

Before 1949 the law gave different income tax treatment to "market value" and "below market value" stock options received by employees. The market value option, that is, a right to purchase shares of the capital stock of the employer corporation within a future period at option-date market value, was not regarded as a form of compensation. Any profit derived from a sale of shares acquired under the option was a capital gain.

Below-market options, on the other hand, created immediate income in the hands of the employee to the extent of the difference between market value and option price of the shares obtainable under the option agreement. It was not necessary that such an option should be exercised to create income subject to tax. Any profit attributable to appreciation of the value of stock acquired under the option was treated as a capital gain.

During the 1949-1952 taxation years the provisions of s. 25 of the Income Tax Act were probably broad enough to support the taxation of capital gains above option-date market value wherever the option was granted as compensation to an employee. There are no court decisions on this point.

Since 1952 s. 85A of the Act has required uniform treatment of all employee stock option benefits. Briefly, the rules are as follows:

(a) No tax liability arises when the option is acquired.

(b) A taxable benefit is deemed to have been received by the employee when the option is exercised.

- (i) by the employee optionee, or
- (ii) by a person who has acquired the shares after acquiring the option from the employee through one or more transactions between persons not dealing at arm's length.

(c) A taxable benefit is deemed to have been received by the employee if he transfers or otherwise disposes of the option itself to an arm's length transferee, whether the transferee acquires the option directly or from a person who acquired it from the employee through one or more non-arm's length transactions. The amount of the taxable benefit in this type of case is the value of the consideration for the disposition.

(d) The rate of tax applicable to the taxable benefit is the average effective rate of tax for the preceding three years (calculated as if net income were taxable income and excluding any stock option benefits or the tax thereon for any of the three years) minus 20. For example,

Assume three-years' income (single person)		\$ 45,000
Taxable income		\$ 14,000 a year
Tax is \$2,720 plus 38% of \$2,000		\$ 3,480
Total tax in three years		\$ 10,440

$$\frac{\text{Total tax}}{\text{Aggregate income}} = \frac{\$\ 10{,}440}{45{,}000} = 23.2\%$$

Applicable rate = 23.2% minus 20 = 3.2%

The rate applicable to a stock option benefit increases as income increases. For example, a single person earning $41,000 a year pays tax on an option benefit at the rate of 17.4%.

(e) Employee stock option benefits, if taxable under s. 85A, are not taxable under any other provision of Part I of the Income Tax Act.

(f) Section 85A applies where a corporation has agreed to sell or issue its own shares or shares in a subsidiary corporation or other non-arm's length affiliate to an employee of the corporation or of its subsidiary or affiliate.

(g) An employer corporation, subsidiary or affiliate cannot deduct the cost of providing stock option benefits to its employees.

(h) If a trustee acquires shares absolutely or contingently for an employee, the employee is deemed to have acquired the shares at the time when the trustee acquired them.

(i) Where an employee "ceases to be an employee" before exercising an option or selling shares acquired under an option, s. 85A continues to apply as though the employment were still in existence.

(j) Section 85A does not apply "if the benefit conferred by the (option) agreement was not received in respect of, in the course of or by virtue of the employment" (s. 85A(7)).

The wording of s. 85A presents several problems, the solution of which will require litigation or amending legislation. Examples are:

Does the section apply to benefits received by an employee under an option agreement entered into before he became an employee? Probably it does not, in view of s. 85A (7) supra.

Does the word "transactions" in s. 85A(1)(c) and (d) include inter vivos or testamentary gifts? If so, option rights or shares acquired by gift or inheritance give rise to additional tax liability of the donor or decedent "in the taxation year in which (the donee or beneficiary) acquired the shares". In the case of an inter vivos gift of rights it can be expected that such an interpretation of the section is workable. But in the case of transmissions at death it becomes absurd. A beneficiary need only wait until the fourth year after death before exercising the option in order to establish a zero tax, zero income and zero rate of tax under s. 85A(2).

Does the word "transferred" in s. 85A(1)(b) include gifts? On the authorities it does: Thomas v. Marshall (I. of T.), (1953) 1 All E.R. 1102 (H.L.). It also includes loans and probably includes any form of hypothecation of option rights.

Does s. 85A(5)(a) exclude the operation of s. 8(1) in shareholder-employee situations? If so, substantial shareholders of closely-held corporations may be well advised to take bona fide employment with their corporations if they wish to substitute stock option benefits for taxable dividends. In the usual case the marginal tax advantage of the s. 85A credit over the s. 38 dividend tax credit is 15% of the amount of the corporate distribution.

A comparison of s. 85A with the United States "restricted stock option" (Internal Revenue Code §421) indicates that the Canadian treatment of employee stock option benefits is much more liberal than the American. United States taxpayers pay tax on their benefits at the capital gain rate of 25%. In addition, they must not sell their option stock within two years of the date of option or within six months of the date of acquisition of the stock. Further, if the option price is below 85% of market value at the date of option the whole agreement falls outside §421. In addition, if the option price is below 95% of market value at the date of option the spread between market value and option price is taxable as ordinary income. The only advantage in the United States scheme of things appears to be the postponement of tax until the stock is sold.

As it now stands s. 85A of the Income Tax Act is the answer to the personal income tax problem of the executive group in our business community. Under favourable market conditions it can reduce the effective rate of tax upon high bracket income to a level below the lowest level imposed by the Act.