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INCENTIVES AND BENEFITS

This regular feature is edited by Julie Y. Lee, of Osler, Hoskin & Harcourt LLP. It examines major trends and tax planning issues pertaining to executive incentive and benefit plans and arrangements.

STOCK OPTIONS

Imperial Tobacco Canada Limited v. R.: Re-opening the Debate on the Deductibility of Stock Option Cash-Out Payments in the Course of Corporate M&As

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In the context of corporate acquisitions, it is often commercially expedient to eliminate all of the previously issued employee stock options of the target corporation ("TargetCo"). While this objective can be accomplished in a variety of ways, the need of the acquiring corporation ("AcquirorCo") to acquire all of the shares of TargetCo, without making special provision for optionholders, and the desire of TargetCo to ensure its optionholders receive the economic benefits of the sale of the company, without necessarily having to come up with the funds to pay the stipulated exercise price, often lead to an arrangement where the optionholders are permitted to surrender their vested and unvested options in exchange for a cash payment equal to the "in-the-money" value of the options.[1] A controversial issue that arises in the course of such cash-out payments is whether TargetCo will be permitted a deduction for the cash expense. The recent decision of the Tax Court in *Imperial Tobacco*[2] adds more fodder to the debate and, perhaps, presents an opportunity for greater deductibility of cash-out payments.

Background

Where a cash payment is made to compensate an employee for the surrender of a stock option, a critical issue, from TargetCo's perspective, is whether TargetCo (or, after the transaction, AcquirorCo) will be permitted a deduction for what is often a large cash outlay. The key issue is whether the payment is on account of capital,[3] in which case a deduction is precluded by virtue of paragraph 18(1)(*b*) of the Act.

The position generally taken by taxpayers is that this type of cash-out payment is in the nature of an employment compensation expense and accordingly, should be deductible pursuant to subsection 9(1). Indeed, that position has been accepted by the Canada Revenue Agency (the "CRA") with respect to cash-out payments made in the ordinary course (i.e., not in circumstances similar to those in *Kaiser* (discussed below)).[4] That position notwithstanding, prior to *Imperial Tobacco*, the only two cases on point – *Kaiser*[5] and *Canada Forgings*[6] – raise significant concerns about the deductibility of cash-out payments made in the course of takeover transactions.

In the earlier case, *Canada Forgings*, the taxpayer corporation had entered into stock option agreements with its president and vice-president. A private holding corporation, of which the two executives were the sole shareholders, held 85% of the shares of the taxpayer. The shares of the taxpayer were acquired by an arm's-length purchaser and, a month thereafter, the purchaser and the two executives entered into a separate agreement under which both of the executives relinquished their rights to acquire shares of the taxpayer under the options in exchange for $325,000, being the in-the-money value of the options. In computing its income under the Act, the taxpayer treated these payments as deductible compensation expenses paid to key employees. The evidence adduced at trial indicated that the purpose of the payment was to enable the purchaser to secure 100% of the shares of the taxpayer corporation. At trial, the Federal Court held that the payment was capital in nature, primarily on the basis that the payment was non-recurring, was made at a time the purchaser was attempting to acquire 100% of the shares of the taxpayer, and that its large size indicated it was an item of capital structure. By itself, *Canada Forgings* might not be particularly concerning in most circumstances, since it could presumably be distinguished on the basis that it involved a large payment to only two employees, both of whom were also the selling shareholders of the taxpayer.

The second case, *Kaiser*, is more troublesome from a deductibility perspective. In that case, a U.S. company agreed to sell its shares of a Canadian company ("Canco") to an arm's-length purchaser, Kaiser Resources. In the sale agreement, an undertaking was provided to attempt to eliminate any outstanding options held under Canco's stock option plan by offering to make a cash payment to its option holders. Shortly after executing the sale agreement, Canco's board of directors passed a resolution amending the stock option plan to remove any vesting restrictions and to allow the cash payment to be made. Canco then made a cash offer, which was accepted by most of the optionholders and the stock option plan was subsequently cancelled. The evidence at trial indicated that one of the purposes of the cash-out payment was to ensure that key employees would stay with Canco, by eliminating uncertainty with respect to the new ownership and options. In the course of time, all of the shares of Canco were then acquired by Kaiser Resources. In computing its income, Canco deducted the option cash-out payments as a current expense. Canco was successful at trial, with the Federal Court holding that the payment was a current expense in that it was a *bona fide* payment made to employees in fulfillment of a condition of employment.

At the Federal Court of Appeal, however, the deduction of the cash-out payments was denied. The Court held that, because the cancellation of the stock option plan was of lasting benefit to Canco 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 ....

The reasoning in *Kaiser*suggests that any once and for all payment which has a direct effect on the capital structure of the payor corporation could be rendered a non-deductible capital expenditure.[7] This reasoning has been subject to much criticism, primarily because the suggestion that Canco's "purpose" in cashing out the options was irrelevant is in conflict with the established jurisprudence, which indicates that the purpose of an expense is always relevant in determining whether it is on income or capital account. Nevertheless, *Kaiser* remains the leading case on the issue.

Imperial Tobacco

In *Imperial Tobacco*, the Tax Court was able to distinguish *Kaiser* to find that a reimbursement by Shoppers Drug Mart Ltd. ("SDM") to its parent ("Parentco") for one-time cash-out payments made to the taxpayer's employees in the course of a takeover of Parentco was on account of income and properly deductible. In that case, key employees of SDM were granted options to purchase Parentco shares under an employee stock option plan. The stock option plan permitted optionholders to exercise vested options for shares and permitted Parentco to offer an optionholder the opportunity to surrender vested options for a cash-out payment. In March 1999, Parentco entered into negotiations with one of its significant shareholders to discuss its privatization. In June 1999, the stock option plan was amended to provide employee option holders with an automatic cash-out right. In August 1999, Parentco entered into an agreement with a Bidco which provided for the acquisition of all Parentco's publicly-held shares, significant changes to Parentco's holdings and share structure, and finally, a disposition of SDM. The agreement further provided that Parentco would cause the accelerated vesting of all outstanding options and would encourage the exercise or surrender of the options before completion of the reorganization.

After approval of the transactions by Parentco's shareholders, optionholders received a cash-out payment and Parentco undertook to fund the cash-out payments[8] and, by letter agreement, SDM agreed to reimburse Parentco for the amount of the cash-out payments, aggregating approximately $55 million. SDM treated this as a deductible expense in computing its income.

The Tax Court began its analysis 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." In the Court's view, this general premise was unchanged by the cash-out occurring as a direct result of the reorganization of Parentco. In particular, emphasis was placed on the fact that SDM was a separate corporate entity, the capital structure and business of which was not affected by the cash-out payment. Thus, in the Court's view, even if one reason for the option acceleration and cash-out payment was to facilitate the acquisition of all outstanding Parentco shares, it did not turn the revenue expense into a capital expense:

> 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.* [emphasis added]

The CRA relied, to a large extent, on the decision in *Kaiser*, but the Tax Court concluded that the facts before it were sufficiently different to distinguish *Kaiser.* Counsel for SDM argued that there were two major factual differences – first, the payment in *Kaiser* was made to terminate the stock option plan, whereas, in SDM's circumstances, the payment did not result in the termination of the stock option plan; and second, in *Kaiser*, the genesis of the payment was the takeover agreement, whereas in SDM's circumstances, the genesis was in the stock option plan itself. While not overly enamored with the second, the Tax Court appeared to agree with the first, and reiterated that, unlike *Kaiser*, no lasting benefit of a capital nature was achieved.

Future Implications

In analyzing what can be taken from *Imperial Tobacco*, it does, at the very least, lend credence to the position taken by many tax practitioners that not all cash-out payments made in the context of a corporation acquisition are governed by *Kaiser.* It would appear that *Kaiser* may be limited to its precise facts – i.e., a situation where a corporation's stock option plan is amended and a cash-out payment made in order to facilitate a takeover of the corporation which occurs in the course of the transactions. The result in *Imperial Tobacco* suggests that two different tax results can follow a cash-out payment made in the course of a takeover transaction, depending on the organization structure of the Targetco. For example, where Targetco is a public corporation which directly carries on business, a cash-out payment made in the course of a takeover of Targetco could be rendered non-deductible by virtue of *Kaiser.* On the other hand, if Targetco is a public corporation which acts solely as a holding company in circumstances where options are granted to employees of operating subsidiaries, it would appear possible to structure a cash-out payment by a subsidiary as being deductible, even if made in the course of a takeover of Targetco, so long as the business and capital structure of the subsidiary remains the same.

From a policy perspective, it is difficult, in the writers' view, to reconcile these two vastly differing results – why should it matter if the takeover target is the parent corporation or the subsidiary corporation – the end result in both circumstances would appear to be the same.

Other than the distinction in corporate structure, it is difficult to pinpoint the pertinent factors in the analysis. The size of the payments, ranging from $650,000 in *Canada Forgings* to $55 million in *Imperial Tobacco* does not appear to be a significant factor. Similarly, the primary and secondary purposes of the cash-out payments do not appear to play a major role, since *Kaiser*offered the clearest evidence of an intention to reward and retain employees, whereas in *Imperial Tobacco*, no such evidence existed, although the Tax Court did note that the payments clearly had as a key purpose compensation.

It may be that the Tax Court in *Imperial Tobacco* was simply taking a more practical approach to the issue than did the Federal Court of Appeal in *Kaiser*and, being bound by the doctrine of *stare decisis*, was left only with the possibility of distinguishing *Kaiser* on its facts. Certainly, the commercial reality surrounding stock options has shifted fairly dramatically since *Kaiser* was decided. In the early 1990s, stock options were reserved, to the main extent, to high-ranking executives whereas, today, stock options are a widely-used form of compensation and percolate through all ranks of an organization. Today's reality is that the vast majority of employee stock options are either surrendered for cash or are exercised and the shares acquired thereunder immediately disposed of on the market. Perhaps more so today than at any other time, stock options are truly more in the nature of employee compensation than a form of equity right in the grantor corporation.

Somewhat surprisingly, an appeal to *Imperial Tobacco* has not been filed and, until such time as the courts articulate the extent to which *Imperial Tobacco* can be used as a basis to help ensure deductibility of cash-out payments, *Kaiser* will continue to cause concern on the issue. As such, on a go-forward basis, perhaps the best advice is to structure arrangements with a view to parallel, to the extent possible, the circumstances in *Imperial Tobacco* and distance the situation from that in *Kaiser*. For example, in drafting the stock option plan, terms could be included to provide for the automatic acceleration of vesting of options in the event of a "change of control" or similar transaction, with a limited exercise period and automatic termination of the options thereafter and the right of an employee to surrender their stock option in exchange for cash, independent of any particular transaction. Such terms would make it unnecessary to amend the stock option plan in the course of a takeover, unlike the situation in *Kaiser*. Although perhaps only a question of optics, the fact that the unexercised options would be terminated would also preclude the necessity to actually cancel the stock option plan post-transaction. Where it is possible to fit into the facts in *Imperial Tobacco*, prior to entering into any negotiations regarding a takeover or merger, contractual arrangements could be entered into between the corporation with the stock option plan and any of its operating subsidiaries, whereby the operating subsidiaries would agree to make reimbursement payments to the parent entity similar to the arrangements in *Imperial Tobacco*. [9] Lastly, in entering into any pre-acquisition agreement or sales agreement, there should be no representation or warranty that a cash-out payment will be made or even offered and any amendments to the stock option plan which are required should be made outside of any such agreement and without reference to the agreement.

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[1] The "in-the-money" value is generally computed as being the difference between the fair market value of the TargetCo shares that could be acquired under the option less the exercise price that would need to be paid. The opportunity to surrender the stock options 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*) of the Income Tax Act, R.S.C. 1985, c. 1 (5^{th} Supplement), as amended, hereinafter referred to as the "Act." Unless otherwise stated, statutory references in this article are to the Act.

[2] *Imperial Canada Tobacco Limited (Successor by amalgamation to Shoppers Drug Mart Limited) v. Her Majesty The Queen*, 2007 TCC 636.

[3] The other requirements – i.e., whether there has been an expense incurred for the purpose of gaining or producing income from a business (paragraph 18(1)(*a*)) and whether the payment is reasonable (section 67) would generally be expected to be satisfied.

[4] See, for example, CRA *Document* 2000-0048355 (November 14, 2000).

[5] *Kaiser Petroleum Ltd. v. The Queen,* 90 DTC 6603 (FCA).

[6] *Canada Forgings Ltd. v. The Queen*, 83 DTC 5110 (FCTD).

[7] Indeed, the CRA has taken this position with respect to other transaction costs, with varying degrees of success. See, for example, CRA *Document* 2006-0195981C6 (October 5, 2006).

[8] The cash-out payments equaled the in-the-money value of the options, plus a grossed-up amount to provide for economic treatment comparable to that available under paragraph 110(1)(*d*).

[9] Care would need to be taken in drafting any such reimbursement payments to avoid the possible application of paragraph 12(1)(*x*) or subsection 15(1).

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