INCENTIVES AND BENEFITS

Stock Option Deduction Under Paragraph 110(1)(d): Unexpected Issues Arising in the Context of Corporate Acquisitions

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Introduction

For employees of public corporations, stock options have traditionally represented the "holy grail" of equity-based compensation. This preference for stock options has, at least in part, been driven by the preferential tax treatment afforded to employee stock options under the provisions of section 7[1] and paragraph 110(1)(*d*) of the Income Tax Act.[2] In particular, in order to parallel the treatment given to capital gains, paragraph 110(1)(*d*) allows an employee optionholder a deduction equal to one-half of the amount of the employment benefit deemed to have been received by the employee at the time of exercising and/or surrendering the option[3] if certain conditions are met: (i) the employee optionholder must deal at arm's length with the employer, the entity granting the option, and the entity whose shares can be acquired under the option immediately after the option has been granted; (ii) the exercise price under the option must be at least equal to the fair market value of the underlying shares at the time the option is granted;[4] and (iii) the share which could have been acquired under the option must qualify as a "prescribed share" at the time the option is exercised or surrendered.

Where a target corporation ("TargetCo") is the subject of an acquisition proposal by another corporation ("AcquirorCo"), it has become relatively commonplace for the vesting of employee stock options to be accelerated, thus giving the TargetCo optionholders the opportunity to exercise the options and tender the TargetCo shares so received to the bid by AcquirorCo or, alternatively, to surrender the options in exchange for a cash payment equal to the in-the-money amount. In ensuring that employees who elect either of these options remain entitled to claim the 50% deduction permitted by paragraph 110(1)(*d*), it is critical that the TargetCo shares be qualified as "prescribed shares" at the time the option is exercised or surrendered. It is this requirement that can often raise surprising issues in the context of a corporate acquisition transaction – the issues that arise in this regard are the subject of this article.[5]

Regulation 6204 Generally

Regulation 6204 sets out the requirements for a share to constitute a "prescribed share" for the purposes of paragraph 110(1)(*d*). Broadly speaking, a share will not be a prescribed share if it has any of the characteristics of a preferred share or is convertible into any share having any of the characteristics of a preferred share.

A review of the original Budget papers surrounding the introduction of the stock option deduction indicates that the policy behind the prescribed share requirement is that the deduction should be available only where the employee optionholder is granted the right to acquire true "equity" shares (i.e., shares where there is no guarantee of an increase in value).[6] 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, impact the status of a share that was previously a prescribed share and cause it to cease to so qualify. In particular, the vast majority of acquisition structures involving public corporations include pre-acquisition agreements entered into between AcquirorCo, TargetCo, and, sometimes, key shareholders of TargetCo. A pre-acquisition agreement of this type is generally intended to provide 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 AcquirorCo, any "lock-up" agreements with major shareholders, and how TargetCo will be operated in the intervening period. The entry into, and the terms of, such a pre-acquisition agreement may give rise to unexpected problems in satisfying the prescribed share requirement.

In this context, as discussed in greater detail below, three requirements are noteworthy:

- 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 is not limited to a maximum amount at that time or at any time thereafter;

- Regulation 6204(1)(*a*)(iv) – under the terms and conditions of the share or any agreement in respect of the share or its issue, the holder of the share cannot at that time or at any time thereafter cause the share to be acquired by the corporation or any specified person in relation to the corporation; and

- Regulation 6204(1)(*b*) – the corporation or a specified person in relation to the corporation cannot reasonably be expected to, within two years after the time the share is sold or issued, acquire the share in whole or in part.

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

It has become increasingly common for pre-acquisition agreements to contain provisions which prohibit the board of directors of TargetCo from declaring or paying any dividends in excess of a specified amount. The concern with this type of prohibition is whether the pre-acquisition agreement is an "agreement in respect of the share," within the meaning of Regulation 6204(1)(*a*). If it is, the prohibition on dividends may constitute a violation of the requirement in Regulation 6204(1)(*a*)(i) that the dividend entitlement on the shares not be limited to a maximum.[7]

Arguably, a pre-acquisition agreement of the sort described above should not be seen to be an "agreement in respect of the share," within the meaning of Regulation 6204(1)(*a*)(i), on the basis that no TargetCo optionholder is a party, the agreement does not impact the terms and conditions of the TargetCo shares themselves, and, at most, the prohibition in the agreement with respect to dividends is a restriction on a

discretionary power of the directors of TargetCo but does not alter the rights of the holders of the shares. This argument is supported by reference to subsection 24(3) of the *Canada Business Corporations Act* (the "CBCA") (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.

The difficulty with the foregoing argument is that the courts have given a very broad meaning to the phrase "in respect of,"[8] as basically implying any connection between two things. Nevertheless, viewed in light of the policy purpose of Regulation 6204 (which is to prevent shares with a "fixed value" from being prescribed shares), there is a reasonable view that a pre-acquisition agreement is not an agreement of the type contemplated by Regulation 6204(1)(*a*)(i). Interpreting the provision in this way would also be consistent with the provisions of the governing corporate legislation.

To date, however, the CRA does not appear to have any published administrative positions on point. Thus, to the extent it is commercially feasible, it is generally desirable 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. An example would be a clause which provides that, for every dividend declared of $1.00 per share, the offer price to be paid by AcquirorCo will be decreased by $1.25 per share (i.e., a disproportional or "punitive" reduction).

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

Regulations 6204(1)(*a*)(iv) and 6204(1)(*b*) will prevent a TargetCo share from being a prescribed share where: (i) 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;[9] or (ii) where there is a reasonable expectation that such a specified person will acquire the share within two years from the date of its issue.

Where the terms and conditions of the TargetCo options contemplate the acceleration of the vesting of those options for the purpose of their exercise and the tender of the TargetCo shares so acquired to the bid by AcquirorCo, it would appear that there is a reasonable expectation that AcquirorCo will acquire those shares. The question is thus whether AcquirorCo will be a "specified person" of TargetCo, within the meaning of Regulations 6204(1)(*a*)(iv) and 6204(1)(*b*).

In this respect, 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.

In this regard, to the extent that a pre-acquisition agreement can be said to give AcquirorCo a future contingent right to acquire greater than 50% of the TargetCo shares (e.g., through lock-up agreements, etc.), AcquirorCo and TargetCo will then be considered to deal at non-arm's length pursuant to the interaction of paragraphs 251(5)(*b*),[10] 251(2)(*b*) and 251(1)(*a*).[11] Thus, unless the transaction can fit within the exclusion for rights arising due to "an offer [by AcquirorCo] to acquire all or substantially all of the shares of [TargetCo]," the mere entry into the pre-acquisition agreement could cause the TargetCo shares to cease to be prescribed shares for the purposes of the paragraph 110(1)(*d*) deduction.

While the policy behind 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 only apply to ensure that AcquirorCo is not a specified person in relation to TargetCo at the time the TargetCo options are exercised or surrendered if:

- The TargetCo options are exercised or surrendered before AcquirorCo actually acquires control of TargetCo (at which time AcquirorCo would be a specified person even in the absence of any paragraph 251(5)(*b*) rights);

- AcquirorCo's rights to acquire TargetCo shares arise from an "offer;" and

- AcquirorCo's rights to acquire TargetCo shares arise from an offer to acquire "all or substantially all" of the TargetCo shares.

The first requirement, i.e., timing, should be manageable in most situations. In this regard, for example, all options could be open for exercise or surrender only until the point in time which immediately precedes the acquisition of TargetCo shares by AcquirorCo.[12] The latter two requirements raise, however, several issues, some of which are discussed below.

(1) Non-Offer Acquisition Structures

Not all takeovers and corporate acquisitions take the form of an "offer" by AcquirorCo. For example, AcquirorCo 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 AcquirorCo pursuant to subsection 87(9). Based on the discussion above, it is possible that AcquirorCo may become a specified person in relation to TargetCo as soon as the arrangement agreement or amalgamation agreement is signed, but will not be able to benefit from the carve-out in Regulation 6204(3) on the basis that AcquirorCo's rights do not arise under an offer for all or substantially all of the shares of TargetCo.[13]

As a consequence, the shares that can be acquired under the TargetCo options may not qualify as prescribed shares, with the result that optionholders who exercise or surrender their options after the execution of the arrangement or amalgamation agreement will not technically qualify for the 50% deduction pursuant to paragraph 110(1)(*d*). This result is clearly inappropriate from a policy perspective – TargetCo optionholders should not be subject to different tax consequences depending on the form of transaction through which AcquirorCo and TargetCo are combined.

This anomaly was the subject of submissions made by the Joint Committee on Taxation of the Canadian Bar Association and the CICA to the Department of Finance on July 29, 2005 (the "2005 Submissions"). The Joint Committee recommended that the definition of "specified person" should exclude all persons or partnerships who are only deemed non-arm's length 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 AcquirorCo. While not explicitly mentioned in the 2005 Submissions, the latter "broadening" should also encompass situations where TargetCo is merged with a subsidiary of AcquirorCo.

Nevertheless, if and until legislative relief is provided, it is generally inadvisable for TargetCo optionholders to exercise or surrender their TargetCo options after the arrangement agreement or amalgamation agreement is signed. Rather, where the tax treatment to TargetCo optionholders is of importance, the transaction should be structured so that the TargetCo options survive post-transaction or are exchanged, under subsection 7(1.4),[14] for options of AcquirorCo.

(2) Where AcquirorCo Already Owns 11+% of TargetCo

The exclusion from the specified person definition in Regulation 6204(3) applies only where the offer by AcquirorCo is one to acquire "all or substantially all" of the TargetCo shares. The CRA's widely published position in this regard is that the phrase "all or substantially all" means 90% or more, although the jurisprudence on the issue indicates that the 90% threshold is not a bright line test. Nevertheless, an issue which arises in this regard is whether this exclusion will apply where AcquirorCo already owns, for example, 20% of the TargetCo shares and hence makes an offer for only the remaining 80% of the TargetCo shares.

In its 2005 Submissions, the Joint Committee suggested that "common sense" dictated that the words "not already owned [by the AcquirorCo]" should be read into the all or substantially all criterion. While there is, to the writer's knowledge, no CRA commentary directly on this point, the CRA has accepted this sort of interpretation with respect to similar language contained in subsection 186(2) of the *Excise Tax Act*. [15] That being said, legislative clarity in this respect is desirable.

(3) Where AcquirorCo Is Not Acquiring All Shares of TargetCo

An issue also arises where AcquirorCo proposes to purchase something less than all the TargetCo shares. For example, AcquirorCo may be desirous of only acquiring majority control of TargetCo (i.e., 51% of the common shares) or achieving a 66 2/3% threshold. AcquirorCo may not, for example, wish to acquire the non-voting preferred shares of TargetCo. While such an offer may nevertheless constitute a "take-over bid" for the purposes of applicable securities laws,[16] the exclusion from the specified person definition in Regulation 6204(3) may not be available, given that the offer by AcquirorCo is for less than 90% of the shares of TargetCo.

In its 2005 Submissions, the Joint Committee recommended that the "all or substantially all" threshold in Regulation 6204(3) be deleted and replaced with a test that requires only a majority of TargetCo's shares to be held by AcquirorCo after the transaction. As above, however, if and until legislative relief is provided, in structuring this type of "partial-offer," care should be taken to ensure that the TargetCo options survive post-transaction or are exchanged, under subsection 7(1.4), for options of AcquirorCo.

Conclusions

Corporate acquisition proposals of public corporations often come at a price which offers the TargetCo shareholders a significant premium over the current trading price of the TargetCo shares. In order to ensure that TargetCo optionholders are entitled to share in such a premium, without being subject to unduly harsh tax treatment, it is critical to ensure that the transaction is structured so that Target optionholders who choose to exercise or surrender their options are entitled to the 50% deduction provided for by paragraph 110(1)(*d*). As a consequence of the technical rules in Regulation 6204 relating to what will constitute a prescribed share for the purposes of paragraph 110(1)(*d*), unexpected issues can arise in the context of a corporate acquisition transaction and care should be taken to ensure that these issues are adequately dealt with.

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[1] The rules surrounding the application of section 7 are not discussed herein and a general understanding is assumed.

[2] 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.

[3] The CRA's long-standing administrative position is that the paragraph 110(1)(*d*) deduction may be available even where the employee optionholder can surrender his or her options for payment of the in-the-money amount in cash or shares, so long as the choice to surrender is the employee's and the requirements of paragraph 110(1)(*d*) are otherwise met.

[4] In the case of a public corporation, this condition is also mandated by the restrictions imposed by stock exchange regulators.

[5] For a discussion of some of the other issues that can arise in the context of stock options in corporate acquisitions, see Jeremy J. Forgie and Elizabeth Boyd, "Tax Issues Relating to Stock Options in the Context of Corporate Mergers, Acquisitions and Reorganizations" (December/January 2000) 11 *Taxation of Executive Compensation and Retirement* 224.

[6] See 1984 Budget Supplementary Papers. Along these lines, in Janette Pantry, "Paragraph 110(1)(d) – Stock Option Deduction – Unwarranted Application of Prescribed Share Provisions" (July/August 2005) 17 *Taxation of Executive Compensation and Retirement*563, it is suggested that the intent was to ensure that the 50% deduction would not be available where ordinary salary is replaced with an option to acquire a retractable preferred share where the retraction price was guaranteed to increase over time.

[7] For further discussion, see Gabrielle M.R. Richards, "Recent Transactions," *Report of Proceedings of Fifty-Fifth Tax Conference*, 2003 Tax Conference (Toronto: Canadian Tax Foundation, 2004), 29:1-20.

[8] See, for example, *Nowegijick v. The Queen*, 83 DTC 5041 (S.C.C.), 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" 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.

[9] 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, as that provision does not rely on there being an agreement in respect of the share.

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

[11] Depending on the factual circumstances, the agreement may also result in AcquirorCo and TargetCo dealing at non-arm's length in fact.

[12]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 provision would have otherwise deemed the acquisition of control to have occurred at the first moment of the day on which the TargetCo shares were acquired by AcquirorCo.

[13] For further discussion, see Jeffrey Trossman, "Triangular Amalgamations," *Report of Proceedings of Fifty-Third Tax Conference*, 2001 Tax Conference (Toronto: Canadian Tax Foundation, 2002), 22:1-32.

[14]Subsection 7(1.4) generally permits an exchange of options on a tax-deferred basis so long as the "in-the-money" amount of the options is not increased.

[15]Subsection 186(2) of the ETA permits a registered corporation to claim ITCs 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 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 its potential application with respect to Regulation 6204, see Glen Loutzenhiser, "Prescribed Share Concerns When Employee Stock Options Are Exercised During a Takeover Bid" (May 2002) 13 *Taxation of Executive Compensation and Retirement* 131.

[16]Most provincial securities acts define take-over bid as an offer to acquire securities that, together with the offeror's securities, would constitute 20% or more of the outstanding securities of that class.

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