Pyrrhic Policy: Fixing the Phantom Loophole in Paragraph 7(3)(b)

Robin J. MacKnight*

PRÉCIS

Il y a quarante ans, de nouvelles règles sur le traitement fiscal des avantages découlant des régimes d'options d'achat d'actions et des régimes d'achat d'actions ont été insérées dans la Loi de l'impôt sur le revenu. Trente-neuf ans plus tard, la Cour d'appel fédérale a dû se prononcer sur l'application de ces règles, selon lesquelles une déduction au titre des avantages accordés aux employés par voie de régimes d'options d'achat d'actions et des régimes d'achat d'actions est refusée aux employeurs. Selon l'auteur de cet article, la décision de la Cour d'appel fédérale dans l'affaire *La Reine c. Placer Dome Inc.* constitue un exemple des résultats artificiels et déformés d'une modification législative qui n'a réglé aucun problème. Il suggère que la solution consiste à abroger l'article en cause.

ABSTRACT

Forty years ago, new rules were introduced into the Income Tax Act governing the tax treatment of stock option and stock purchase plan benefits. Thirty-nine years later, the Federal Court of Appeal had to determine the operation of those rules, which deny an employer a deduction for benefits that are conferred on employees through stock option or stock purchase plans. This article posits that the Federal Court of Appeal decision in *The Queen v. Placer Dome Inc.* illustrates the artificial and distortionary results of a legislative amendment that cured no ill, and suggests that the solution is the repeal of the offending section.

> During the last week or so since the bill received first reading I have had numerous representations regarding this clause in the bill which is designed to take care of a loophole which now exists in our law with respect to stock option plans. While the provisions of the clause now before us were designed to cover the relatively narrow field of stock option plans, the proposed legislation does bring into perspective the more general problem of how to treat the more usual type of employee stock purchase plan as distinct from stock option.
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> The Honourable D.C. Abbott, minister of finance, budget debate, in Canada, House of Commons, *Debates*, April 10, 1953, 3720.

> If it ain't broke, don't fix it.
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> Bert Lance, *This Nation's Business*, May 27, 1977, proposing that the United States could save billions of dollars if the country accepted this as its single motto.

* Of Gowling, Strathy & Henderson, Toronto.

In 1953, the government introduced a provision to tax the benefits to employees arising under stock option agreements. This new section 75A, the predecessor to what is now section 7 of the Income Tax Act,[1] contained specific provisions for taxing these benefits. Although legislation was required to change the law to provide the incentives that were contemplated by the budget proposal, the new provision went further, introducing a rule that denied a deduction to the corporate employer in respect of the benefit received by the employee.[2] The introduction of the latter provision might have been supported on the grounds that it was a mere codification of the then prevailing common law;[3] however, it has recently been construed in a fashion considerably broader than, and apparently contrary to, that common law.[4]

This article posits that paragraph 7(3)(b) is an unnecessary and, indeed, distortionary provision. When it was introduced, it cured no ill; the "fix" applied to something that wasn't "broke." The recent Federal Court of Appeal decision in *The Queen v. Placer Dome Inc.* leads to artificial difficulties that the common law had specifically addressed. The tax system is now "broke"; the "fix" is to repeal paragraph 7(3)(b) and return to the common law.

THE COMMON LAW BEFORE THE AMENDMENT

To appreciate the significance of the 1953 amendment and the disruption created by the *Placer Dome* decision, it is necessary to review the state of the common law in 1953.

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[1] RSC 1952, c. 148, as amended by SC 1970-71-72, c. 63, and as subsequently amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

[2] Paragraph 75A(5)(b) provided:

> Where a corporation has agreed to sell or issue shares of the corporation or of a corporation with which it does not deal at arm's length to an employee of the corporation or of a corporation with which it does not deal at arm's length, . . .
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> (b) the income of the corporation for a taxation year shall be deemed to be not less than its income for the year would have been if it had not conferred a benefit on the employee by the sale or issue of the shares to the employee.

The current paragraph 7(3)(b) has only minor changes from the original provision:

> Where a corporation has agreed to sell or issue shares *of the capital stock* of the corporation or of a corporation with which it does not deal at arm's length to an employee of the corporation or of a corporation with which it does not deal at arm's length . . .
>
> (b) the income for a taxation year of the corporation *or of a corporation with which it does not deal at arm's length* shall be deemed to be not less than its income for the year would have been if a benefit had not been conferred on the employee by the sale or issue of the shares to him *or to a person in whom his rights under the agreement have become vested.*

[Substantive changes have been noted; there has also been some reordering of phrases within the subsection.]

[3] *Lowry v. Cons. Afr. Trust*, [1940] 2 All ER 545 (HL) (discussed further, below).

[4] *The Queen v. Placer Dome Inc.*, [1992] 2 CTC 99 (FCA).

No Canadian court had considered the tax position of a corporate employer that conferred benefits on its employees through stock option or stock purchase plans. The English courts, however, had considered the point, and the House of Lords had clear views on the appropriate tax results. It is fair to conclude, then, that the decision in *Lowry v. Consolodated African Selection Trust, Ltd.*[5] was the law in Canada as well as the United Kingdom.

The UK Position

The decision in *Cons. Afr. Trust* emphasized that the corporate employer neither incurred an expense nor transferred assets to its employees who purchased shares at a discount. Consequently, the corporate employer was not entitled to any deduction for the benefit realized by its employees.

In *Cons. Afr. Trust*, the corporate employer agreed to issue, and subsequently did issue, 6,000 shares to its employees at par value when the fair market value of those shares was about nine times that par value. The salaries of those employees had been fully paid quite apart from this issue of shares. The employees who acquired shares were assessed tax on the difference between the market price and that par value. The employer sought a deduction of an equivalent amount. That deduction was denied because the issue of the shares did not involve the employer in any expense for the purposes of its trade.

Viscount Caldecote put the question, and the answer, in this way:

> I ask whether the issue of these shares in the manner adopted involved the respondent in any "disbursement or expenses . . . wholly and exclusively laid out or expended for the purposes of" its trade. Its capital was intact after the issue of the shares. Not a penny was in fact disbursed or expended. Its trading receipts were not diminished, nor do I think it is a right view of the facts to say that the respondent gave away money's worth to its own pecuniary detriment.[6]

Viscount Maugham approached the problem from a slightly different direction:

> Upon an issue of shares, the assets of the company are increased by the amounts obtained from the subscribers. These amounts are obviously not profits or gains of the trade, and they are not liable to be brought into the accounts for income tax. It may be said that these amounts are of the nature of capital, but I prefer for the present purposes to say that beyond all doubt they are not profits and gains arising or accruing from a trade. . . . What I have said is equally true whether the shares are allotted at par or at a premium. The sum of £11,625, which in this case the company might hypo-

[5] Supra footnote 3.

[6] Ibid., at 550. The particular emphasis on the English statute, which denies a deduction unless the expenses are "wholly and exclusively laid out or expended for the purposes of the trade," does not detract from the conclusion that *no* expense was involved in this case. The conclusions in *Cons. Afr. Trust* are not tainted by the statutory language peculiar to the UK statute.

> thetically have received for premiums, was not an item in its profits and gains. . . . Indeed, the issue of shares by a limited company is not a trading transaction at all. The corporate entity becomes *pro tanto* larger, but the receipts of the trade, on the one hand, and the amount of the costs and expenditures necessary for earning these receipts, on the other, remain unaltered, and it is the difference between these two sums which is taxable.[7]

An alternative argument advanced by the employer was that a deduction should be allowed on the premise that if the corporation had issued the shares at market value and then paid that amount to its employees as remuneration, it would have been entitled to a deduction. Viscount Maugham's response was direct:

> Neither of those things happened, and what we have in effect to consider is whether, since the company has not in fact received any part of the sum of £11,625, the premiums which the company might have got and expended, but never did get or expend, can be treated as an expense or deduction laid out or expended in some artificial but legitimate sense for the purpose of the trade of the company. This is a rather difficult proposition to establish in the affirmative.[8]

Viscount Maugham revisited this point in responding to the employer's argument that the "lost" premium constituted an "amount foregone" that should be deductible:

> It is said in effect that the amount of the premiums is "an amount foregone" by the taxpayer because the shares were issued at less than their market value to the employees as "remuneration" for their services, or alternatively, that, if the company had issued the shares in the open market, it could have utilised "the premiums" for the purpose of paying "the aforesaid remuneration," and could then have debited the amount for the purpose of computing its profits for income tax purposes. These are, I think, quite distinct reasons. To the first, I think that the short answer is that an "amount foregone" is not (with one special exception) deductible, and that there is no principle under which such a sum can be treated as a disbursement or expense of the trade. To the second, the reply is that one must look at the events which have happened, and not at those which never happened, and that there is nothing to show that the premiums in question will ever be obtained by anyone either in the year of assessment or in any subsequent year.[9]

Both Viscount Maugham and Lord Russell carefully outlined how the corporate employer could have claimed the deduction. Viscount Maugham explained:

> If money or money's worth in any form, whether from capital or from income, is given to an employee in discharge of an ordinary trading obligation or debt due to him incurred in the course of the trade, and is accepted as such, I am quite ready to accept the view that the amount of the debt or liability so discharged will find its way into the profit-and-loss account on ordinary commercial principles, and will *pro tanto* reduce the profits for the

[7] Supra footnote 3, at 552.

[8] Ibid., at 552.

[9] Ibid., at 554.

> year for income tax purposes. . . . If, in this case, the employees were paying the par value of the shares, and also releasing to the company some amounts of salary due to them, the case would be very different from what it is. All we really have before us is that the company has chosen to issue 6,000 shares at par to the employees, who have received the benefit of that issue. There is really nothing more. The employees have given up nothing. The company has not lost, or parted with, any asset.[10]

Lord Russell had a similar view:

> There is no difficulty about the cases, indicated in the course of the judgment, in which a servant is remunerated in kind. The value of the "kind" must be deducted in ascertaining the profits of the trade, subject, however, to the fact that, if the "kind" is part of the trader's stock in trade, further entries must be made in the account if it is desired to ascertain the profit made by the realisation of all the stock in trade realised, for the "kind" which is applied at its value in remunerating the servant is stock in trade realised just as much as if sold at that value to a customer. The value of the "kind" should, I think, be included in the receipts as representing a realisation at the value at which it discharges *pro tanto* the servant's salary, and the expenses should include, in addition to the cost of the whole stock in trade, an item representing the whole amount of that salary. . . . Transactions such as that, however, do not represent what in fact happened in this case. Here the respondents, in my opinion, parted with nothing. They transferred no assets of theirs to the servants.[11]

Summary of the Common Law Position

Following the House of Lords decision in *Cons. Afr. Trust*, the state of the common law in 1953 (and still, because the case has been cited with approval since[12]) is that:

1) a corporate employer is not entitled to a deduction for any benefit that is conferred on an employee in respect of the difference between the fair market value of a share issued to an employee and the price the employee pays to acquire that share; and

2) a corporate employer is entitled to a deduction that is equal to the fair market value of any payment in kind that is made in satisfaction of a trading expense, including the value of a share issued in full or partial payment of an employee's salary.

This distinction may seem to be based on an outmoded perception that stock "fringe" benefits are somehow gratuitous, in that their value is determined by factors that are beyond the control of the parties and the employee has already been fully compensated for services rendered. In modern employment relationships, such "external" fringe benefits can be an essential part of the overall compensation package. The value of such benefits, however, is still largely determined by factors beyond the control of

[10] Ibid., at 553.

[11] Ibid., at 559.

[12] Including, for example, in *Placer Dome*, supra footnote 4, at 110.

the parties—and opening the doors to deductions based on opportunity costs to corporate employers seems to fly in the face of rules requiring certainty. Although specific statutory provisions would be required to allow a deduction in the first case, paragraph 7(3)(b) disallows bona fide deductions in the second case.

THE 1953 AMENDMENT

As noted above, the amendment introduced special taxing rules for stock option benefits. The original provision (which is no longer contained in the current section 7) taxed the benefit at preferential rates. In the budget debates, Mr. Abbott explained the rationale for this "reasonable degree of relief."[13] Part of the rationale for the preferential tax rate on the employee benefit was the onerous result to the corporate employer:

> A further point in this connection is that although the benefits received by the employee under stock purchase or stock option plans are regarded as income from office or employment, that is, it is regarded as remuneration, the corporation providing remuneration in this form to its employees does not charge it against its profit and loss account for purposes of corporation income tax. Thus it might be said that we are getting corporate income tax in a larger amount because the corporation decides to benefit its employees in this way.[14]

The reference to the corporation's not charging an amount to its profit-and-loss account is clearly to the House of Lords decision in *Cons. Afr. Trust*. As discussed above, however, *Cons. Afr. Trust* contains significant obiter that remuneration in kind, including stock, leads to a deduction. Mr. Abbott's comment thus seems to be an overstatement of the common law. If he intended a statutory repudiation of the express comments of the House of Lords, and a consequent change in tax principles, one would have hoped for more than just a passing reference. Indeed, his subsequent comments in the budget debate suggest that the proposed changes were to be limited:

> I should add that it was not the intention in introducing this legislation to interfere with normal employee stock purchase plans which have been introduced by a number of corporations, but it was felt that it was necessary to prevent an abuse of these stock option devices through allowing employees, perhaps executives of a corporation, to get very large benefits which would not be taxable.[15]

[13] The amount of the stock option benefit was to be reduced by 20 percent. The tax policy behind the explanation seems weak. Mr. Abbott explained "why this 20 per cent abatement against tax appeared to be a reasonable degree of relief. Section 5 of the law, while defining generally the scope of the tax on wages and salaries, provides that certain of what I might call fringe benefits need not be included in income. For example, the benefits obtained under group insurance plans need not be included in income. Neither is the employee required to include in his income the dollar value of his benefits under medical service plans. These facts suggest that it would not be unreasonable to exclude by some device moderate benefits received under stock purchase plans, for example." (Canada, House of Commons, *Debates*, April 10, 1953, 3720.)

[14] Ibid.

[15] Ibid., at 3720-21.

Mr. Abbott's comments were directed to the tax consequences to the *employees*, and to the need to change the existing rules that were applicable to them. It is arguable that his overstatement with respect to the consequences to the employer was meant only to reiterate his view of the common law position, not to suggest that it was "broke." There was certainly no express statement indicating that any "fix" for the employer was intended.

THE CURRENT STATUTORY REGIME

The current section 7 closely resembles the original section 75A. Both sections have three essential provisions:

1) a rule that defines the amount of the benefit that is realized by the employee;

2) a rule that defines when that benefit must be recognized for tax purposes by that employee; and

3) a rule that states that the specific provisions of the section override any other provision of the statute of otherwise general application.

Both sections also have a significant limitation: the section becomes operative only "where a corporation has agreed to *sell or issue* shares of the capital stock of the corporation or of a corporation with which it does not deal at arm's length to an employee of the corporation or of a corporation with which it does not deal at arm's length" [emphasis added].

The effect of this limitation is that section 7 only operates when the corporation is the *source* of the stock. If the corporation provides funds to employees to allow them to acquire shares from a source other than the corporation (for example, the public market), no benefit arises under section 7. This distinction is emphasized in the *Placer Dome* decision.[16]

INTERPRETING THE FIX: THE PLACER DOME DECISION

The recent Federal Court of Appeal decision in *Placer Dome* relies on paragraph 7(3)(b) to disallow the employer's contribution to an employee stock purchase plan. Had this section not existed, the result would have

[16] However, such assistance may give rise to a taxable benefit under another provision of the Income Tax Act. Even Revenue Canada accepts this conclusion. Note, for example, the two advance tax rulings ATR-15 and ATR-17. In *Income Tax Ruling* ATR-15, November 21, 1986, the employees acquired shares from a trustee that acquired the shares initially from the corporation. Section 7 governed the taxation of the employee benefit. However, in *Income Tax Ruling* ATR-17, February 9, 1987, the corporation made contributions to a trustee that used the funds to acquire shares in the public market. Section 7 did not apply either to impute a benefit to the employees (although paragraph 6(1)(g) did) or to deny a deduction to the corporate employer, which was entitled to a deduction under section 32.1 (employee benefit plans). Note also that Revenue Canada did not deny the employer a deduction in *Placer Dome* to the extent that the employer's contributions to the trusteed plan were used to acquire shares from withdrawing or terminated members of the plan. Only the contributions used to subscribe for treasury shares were subject to the operation of section 7. The other amounts contributed to the plan were taxed in the employees' hands as additional remuneration under section 5.

been the same—the common law as laid down by *Cons. Afr. Trust* (cited in the decision) leads to the same result.

The facts in *Placer Dome* are not uncommon. The corporate employer had set up a trusteed employee stock purchase plan. Employees were permitted to contribute up to 6 percent of their salary per annum to this plan; the corporate employer was then required to make a corresponding contribution equal to one-half of the employee's contribution. The trustee of the plan used the total contributions to purchase shares of the employer, at fair market value, first from withdrawing or terminated members of the plan, and then, if necessary, from treasury.

In computing its income, the employer deducted the amount that it had contributed to the plan. On assessment, this deduction was disallowed. On appeal to the Federal Court—Trial Division, the employer's deduction was allowed on the basis that its contributions to the plan were made as additional remuneration to the participating employees. The Federal Court of Appeal denied the deduction because "it is clear that the employer's contributions are provided merely to allow the acquisition of shares by the employees at a reduced price."[17] Although the decision did not rely on this point, the express terms of the plan could be read as reflecting that intent.[18]

The majority decision[19] took great pains in describing the circular flow of funds from the employer corporation to the trustee and back to the employer as subscription proceeds for treasury shares:

> It is impossible to deny, in view of all these rules, that the trustee's function is an automatic, and not an autonomous, one. Every phase of the trustee's activity is specifically predetermined. There is, of course, nothing irregular about such an arrangement, but, it is apparent that the trustee exercises absolutely no independence of thought or action. The trustee is, in fact, a mere executor, an agent or a servant with no power to decide and no initiative whatsoever. . . . He is an intermediary or a conduit acting for the benefit of all concerned and his only role is to execute passively the operations as dictated by the provisions of the Plan and the directives of Placer's Board of Directors.[20]

This circular flow of funds, coupled with the findings that any outlay by the employer had a predetermined destination and that more treasury stock was issued than old stock was sold, led the majority to conclude that the employer "has not made any output of funds under the Plan."[21] The

[17] Supra footnote 4, at 100, per Marceau JA.

[18] Article II of the plan provided: "The purpose of the Plan is to enable Employees to acquire Placer Common Shares through payroll deductions with financial assistance provided by the Participating Company." Ibid., at 101. Financial assistance can take many forms; certainly a discount from market price is one.

[19] Linden JA concurred with Marceau JA. Although agreeing in the result, Mahoney JA disagreed with Marceau JA's finding of fact that no money was ever paid by the employer: see ibid., at 99 and 108.

[20] Ibid., at 108-9.

[21] Ibid., at 110.

proper conclusion was that "the true benefit the employees acquire by their participation in the Plan is not the entitlement to an additional remuneration but the entitlement to a credit for shares of Placer at two-thirds of their market value."[22]

If the *Cons. Afr. Trust* tests were applied to these findings, no deduction could be allowed to the employer for the discount on the employees' purchase of shares. Since the employees had been fully compensated for their services in salary (participation in the employee stock purchase plan was voluntary), it could not be said that employees were remunerated through a "payment in kind" that, under the *Cons. Afr. Trust* tests, would have generated a deductible expense.

Since the common law tests reach the same result as the new statutory tests, one must question the need for the statutory rule contained in subsection 7(3). Furthermore, as discussed below, the broad language of that subsection produces results that cannot be supported on any tax policy grounds. The solution is to repeal the overreaching provision.

THE DISTORTIONS OF PARAGRAPH 7(3)(b): A TRAP FOR THE UNWARY

As noted above, the common law properly resolves the tax treatment of stock option benefits that are not intended as remuneration for services rendered. Furthermore, the common law (apparently accepted by Revenue Canada[23]) properly taxes as income payments that are made by employers to their employees, which payments are then used by the employees to acquire shares from third parties. Paragraph 7(3)(b) goes further, however, to deny the corporate employer a deduction for bona fide wage and salary expenses that are paid in kind, in the form of employer stock. This treatment introduces a horizontal inequity to the Canadian tax system that is not parallelled in other jurisdictions.

To show the horizontal inequity, consider the case of two employers, both of whom wish to have employee ownership and both of whom owe remuneration to their employees. If one employer has access to capital markets and can issue treasury shares into the market to raise new capital to pay salaries to its employees, it will be allowed a deduction for wage and salary expenses. If its employees subsequently use their (after-tax) cash wages to acquire shares in the market, no benefit will be attributed to them under section 7.[24]

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[22] Ibid., at 109.

[23] See ATR-15, supra footnote 16. Note also that in *Placer Dome* the parties settled the issue of deductibility where the employer contributions could be traced to share purchases from third parties (departing employees).

[24] Note that in both of these cases the employees will have an income inclusion equal to either the cash remuneration received or the equivalent "discount" on their stock purchases. For example, if both employees were paid, in cash, a base amount of $90, and one received an additional $10 in cash while the other was allowed to subscribe for treasury shares at a

(The footnote is concluded on the next page.)

If, in contrast, the second employer issues stock that has a fair market value equal to the remuneration that the employer owes to its employees, the benefit to the employees will be taxable under section 7, but the employer will have no deduction for its genuine wage and salary expense paid in kind. Since there is no principle of tax policy that advocates non-deductibility of bona fide business expenses, this inequitable result must be considered a trap for the unwary.

Furthermore, it seems anomalous that in this particular area of deductibility of wage and salary expenses, the corporation should get no recognition for tax purposes for issuing its stock. If a corporation issues stock in exchange for assets, it is generally considered to have acquired those assets at the value of the stock issued (absent the operation of some specific tax-deferral provision of the Income Tax Act). If the corporation pays for inventory by issuing stock, its cost of the inventory will be the value of the stock issued.[25] If it pays trade expenses not with cash but by issuing stock, it still has incurred that expense and, subject to the general rules, is entitled to a deduction. Why should wage and salary expenses be singled out for different treatment?

The UK Position

Cons. Afr. Trust still represents the state of the law in England.

Recent decisions involving the deductibility by employers of payments that are made to trustees of employee plans to acquire shares in employer corporations for the benefit of employees have questioned whether such payments are deductible as "revenue" expenses, or are non-deductible as being on account of capital. The taxpayers seem to be winning the battle.

The current leading case is *Heather v. P-E Consulting Group Ltd.*,[26] in which payments were made by a corporation to a trust that was set up to acquire its shares for the benefit of the employees and to prevent outside interference in management. These payments were held to be deductible because the object of the scheme was to enable the business to be carried on more efficiently, and the expenditures consisted not of a single payment but of a series of annual payments, the aggregate of which was unpredictable.

In this case, the taxpayer was a company of management consultants. Shares of the company were owned by a holding company, 41 percent of the shares in which were owned by the group's pension fund and 59 percent

24 Concluded . . .
$10 discount, both employees would have employment income of $100—one having $100 of income under section 5, the other having $90 of income under section 5 (the base amount) and a further $10 under section 7. The only difference between these cases is whether the corporate employer gets a deduction for the additional $10.

25 See D. Keith McNair, *The Meaning of Cost in Canadian Income Tax*, Canadian Tax Paper no. 69 (Toronto: Canadian Tax Foundation, 1982), 25-28.

26 [1973] 1 All ER 8 (CA).

by outside shareholders with no professional qualifications. On two occasions drastic changes had been made by the outside shareholders, which upset the taxpayer's professional staff. As a result, a plan was introduced to enable the employees to acquire control. This plan took advantage of a statutory incentive plan under the prevailing Companies Act, which allowed a corporation to provide money for a trust fund under which the trustees could purchase the corporation's own shares, or the shares of a holding corporation, provided that those shares were held by or for the benefit of employees of the corporation. Under the plan that was adopted, the taxpayer was to pay 10 percent of the group's consolidated profits to the trustees, with a minimum of £5,000 per year. The trustees were to use that fund to acquire shares in the taxpayer corporation from third parties and the holding corporation so as to acquire control. The trustees were to hold the shares for the benefit of the employees. The trustees offered shares for sale to the employees, but arrangements were made for shares to be bought back by the trust or other employees on the death or retirement of an employee beneficiary. On the termination of the trust, all trust property was to be divided among the employees.

The company asserted that payments made to the trustees were revenue expenditures and were proper deductions to be made in computing the company's tax. The Crown claimed that the payments were on account of capital.

The Court of Appeal considered in detail, and distinguished, the decision in *British Insulated and Helsby Cables v. Atherton*,[27] a case that considered the deductibility of payments to a trusteed pension plan. In that case, however, the payment was made to establish the "nucleus" fund, while in *P-E Consulting* the court concluded that

> the purpose of these payments was to provide an incentive for the staff, to make them more contented and ready to remain in the service of the taxpayer company, and also to help in the recruitment of new staff—they were annual payments too—all of which makes them more like the annual payments in *Atherton's* case than the nucleus fund. They were like the taxpayer company's contributions to a cash profit sharing scheme and to the pension fund. They were all regarded by the taxpayer company as rewards to staff for the profits they had helped to make.[28]

This decision was followed in *Jeffs v. Ringtons Ltd.*[29] and in *E. Bott Ltd. v. Price*.[30] The only recent decision not to follow *P-E Consulting* is *Rutter v. Charles Sharpe & Co. Ltd.*;[31] however, in this case the payments to the trustees were found to be loans rather than expenditures.

[27] [1926] AC 205 (HL).

[28] Supra footnote 26, at 13, per Lord Denning MR.

[29] [1985] STC 809 (Ch. D.).

[30] [1987] STC 100 (Ch. D.).

[31] [1979] STC 711 (Ch. D.).

The US Position

In the United States, the tax consequences to both the employee and the employer depend on whether the stock option or stock purchase plan is "statutory" or "non-statutory."

Definition of Statutory Options

Statutory options are governed by specific sections of the Internal Revenue Code[32] that impose restrictions on both the employer and the employee. They include incentive stock options and options that are issued under an employee stock purchase plan. An option may qualify as a statutory option only if the option is: (1) not transferable (other than by will or by inheritance laws) by the individual to whom it was granted; and (2) exercisable only by the individual to whom it was granted during his or her life. The determination whether an option is statutory is made as of the date it is granted. An option that is statutory when it is granted does not lose its character as a result of subsequent events, nor can an option that is non-statutory when it is granted subsequently become statutory.

A statutory plan is not taxed to the employee until he or she sells the stock that he or she acquired through the exercise of the option. The income so realized may be treated as a capital gain. The employer generally has no deduction.[33]

Statutory options include incentive stock options and options that are issued under employee stock purchase plans. All other compensatory stock options are non-statutory stock options.

Incentive Stock Options

Incentive stock options (ISOs) are statutory options. The term refers to an option that satisfies the ISO qualification requirements in section 422(b) of the Code and that is granted to an individual for any reason connected with his or her employment by his or her employer corporation or by a related corporation. The individual must also satisfy certain employment and holding period requirements.

The employee has no income tax liability when he or she receives or exercises the ISO. The employer has no deduction at any time, unless there is a disqualifying disposition of the stock. The employee is taxed when he or she sells the stock that was acquired with the ISO; a profit may be treated as a capital gain. Failure to hold the stock for the requisite period also makes the exercise taxable to the employee. The employee recognizes ordinary income and the employer has a corresponding deduction in the year of premature disposition.

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[32] Internal Revenue Code of 1986, as amended (herein referred to as "the Code").

[33] See, generally, Code section 421(a)(2).

Definition of Non-Statutory Options

Options that do not meet the requirements for statutory options or that are granted under a plan or an offering that does not qualify are treated as non-statutory options. The income tax treatment of these options is governed by section 83 of the Code (which generally provides rules for property transferred in connection with employment).

A non-statutory option is taxed to the employee at the time it is granted, but only if it has a readily ascertainable value at that time. If it does not have such a value, the benefit is taxed on exercise. The employer has a corresponding compensation deduction in the year the employee realizes the benefit.[34]

Difference Between Statutory and Non-Statutory Options

The principal difference between the tax treatment of statutory and non-statutory options is when the taxable event occurs. Under a statutory option, no income is attributed on the exercise of the option. The taxable event is the sale of the stock that was acquired through the exercise of the option.[35]

For non-statutory options, the taxable event is either the grant of the option or its exercise. Whether it is one or the other depends on whether the option has a readily ascertainable value at the time of its grant. If the option has a readily ascertainable fair market value at the time it is granted, the employee must recognize ordinary income at that time, but not at the time of its exercise or disposal. If the option does not have a readily ascertainable value when granted, the recipient must recognize ordinary income at the time of its exercise or disposal, but not at the time of its grant.

Tax Consequences to the Employer

The rules in section 83 of the Code provide that a deduction is allowable for the value of compensatory property when it is includible in the income of the person who performed the services. This rule applies to all property transfers unless a transfer is specifically excluded from the application of section 83. Since the issue of treasury stock is not excluded, a corporate employer is entitled to deduct the value of its own stock that is issued to an employee in payment for services. The deduction is available for both treasury issues of stock[36] and authorized but previously unissued stock.[37] The deduction is measured by the fair market value of the stock that is transferred even in the absence of a fixed dollar liability. For example, where a profit-sharing agreement provided that employees were to get 25 percent of the profits payable partly in cash and partly in the company's common stock at par, the Tax Court held that the corporation could deduct

[34] Code section 83(h).

[35] Code section 421(a)(1).

[36] Rev. rul. 62-217, 1962-2 CB 59.

[37] Rev. rul 69-75, 1969-1 CB 52.

the fair market value of the stock, not its par value. Although there was no absolute monetary liability, there was a liability in cash plus stock.[38]

When property is transferred in connection with the performance of services, the employer or other person for whom the services were performed can deduct an amount that is equal to the amount included in the gross income of the employee.[39] However, since the value of compensatory property is not includible in the gross income of the employee until his or her rights in the property are vested (either transferable or not subject to a substantial risk or forfeiture[40]), the timing of the deduction to the employer is generally dependent on events that occur after its transfer of compensatory property.

The employer is not entitled to a deduction to the extent that its transfer of property for services constitutes a capital expenditure, an item of deferred expense, or an amount that is properly includible in the value of inventory items. In the case of capital expenditures, the basis of the property is increased at the same time and to the same extent as any amount is includible in the employee's gross income in respect of the transfer. Thus, for example, no deduction is allowed to a corporation on a transfer of its stock to a promoter on its organization, even though the promoter must include the value of the stock in income under section 83 of the Code.[41]

CONCLUSIONS

When it comes to corporate deductibility for wage and salary expenses, Canadian corporate employers are now at a disadvantage compared with their competitors in England and the United States. In common law England, salaries paid in stock are deductible. In the United States, the Internal Revenue Code contains rules that parallel the common law. Only Canada has instituted statutory rules that override the common law and prevent the deductibility of bona fide wage and salary expenses that are paid in employer stock.

The Canadian rule in paragraph 7(3)(b) of the Act is horizontally inequitable and distorts the tax system by preventing employers from satisfying their wage and salary expenses with stock. This provision is inconsistent with the general notion that corporations can recognize for tax purposes costs or expenses that are paid in stock. No tax policy reason for this position was expressed when the provision was introduced, nor can one be shown now.

As discussed above, the common law adequately dealt with the question of the deductibility of wage and salary expenses. There is no compelling

[38] *Package Machinery Co.*, 28 BTA 980 (US Bd. Tx. Ap. 1933); see also *National Bella Hess, Inc.*, 20 TC 636 (1953), aff'd. on another issue 55-1 USTC 9298 (8th Cir. 1955), rehearing denied 55-2 USTC 9642 (8th Cir. 1955).

[39] Code section 83(h).

[40] Code section 83(a)(1).

[41] Code reg. section 1.83-6(4).

reason why the common law rule should be replaced with a distortionary statutory rule. The common law was not "broke" in 1953, and continues to produce the proper results. The 1953 amendment filled a loophole that did not exist—deductions without expenses. Now the system is "broke"; the repeal of paragraph 7(3)(b) and a return to the common law are required to restore it to neutrality.