IN FACT AND IN LAW

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New Tax Provisions for Capital Gains and Stock Options

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Stock Options granted to employees

The federal Finance Minister's budget is an event anticipated by the financial community as well as by the public in general, doubly so this year since the Minister of Finance, the Honourable Paul Martin, had announced on several occasions that Canada was now in an era of budget surpluses, unlike the situation prevailing for a number of years.

So, last February 28, the Canada Budget for the fiscal year 2000-2001 was tabled in the House of Commons. This budget provides a number of tax relief measures for corporations and individuals residing in Canada. We will not analyse all tax relief measures of this budget but only a few issues which appear to us to be of importance to the business community.

For the last few years, offering stock options to employees has been on an upswing. This is, in fact, an inexpensive way for companies to indirectly compensate its employees while creating a certain incentive for them to participate in the growth and success of the company. From a fiscal standpoint, it is advantageous for employees to exercise stock options compared with direct compensation since the employee benefits are taxed at a lower rate than that applicable to salary.

To better illustrate the tax treatment of stock options, let us take, for example, an employee which is given the option to acquire a share from his employer for $10 while the fair market value of the stock is also $10. The employee obtains this option without any amount payable to his employer. When the value of the stock increases to $20 and the employee exercises his option, he makes a $10 benefit. Prior to the February 28 budget, a net sum of $7.50 would have been added to the employee's taxable income if certain conditions were met. In addition, this amount of $7.50 would have been included in the employee's for the taxation year in which he exercised his option, except in the case where the corporation offering this option to its employees was a Canadian-controlled private corporation ("CCPC") (meaning, in general, an unlisted corporation with a maximum of 50% of its voting shares controlled by non-residents of Canada, public corporations or a combination thereof). In the latter case, this amount would only have been included in the employee's income for the taxation year in the course of which he disposed of the acquired shares. This preferential treatment given to employees of CCPC was justified in part by the fact that there was generally no market to trade the stock of such a corporation, and that the employee who exercises his option must pay income tax but does not necessarily have the required cash to pay said tax.

The February 28 budget brings major modifications to the tax treatment of stock options. First, the inclusion rate for taxable benefit is reduced from three-quarters to two-thirds. This reduction is due to the fact that the tax authorities want to give stock options a treatment consistent with that given to capital gains which inclusion rate was reduced to two-thirds in the last budget. Consequently, in the previous example, the employee would only have to add an amount of $6.67 to his income for the taxation year in the course of which he exercised his option or disposed of his stock, as the case may be.

Secondly, to get closer to the tax treatment applicable to stock options in the United States, the Minister of Finance decided that stock options granted by publicly traded companies be subject to tax only when the employee sells the shares if certain conditions are met. From now on, the

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benefits derived from such options shall only be subject to tax when the employee disposes of the shares, upon his death or when he ceases to reside in Canada. Therefore, employees exercising their stock options from publicly traded companies shall benefit from a tax treatment similar to that of CCPC employees. These new measures shall apply to all stock options exercised after February 27, 2000.

Requirements to defer taxing when an employee exercises his stock options are rather binding. First of all, the employee would have to be dealing at arm's length with the corporation and, generally speaking, he would have to hold directly or indirectly at least 10% of the shares of the corporation's share capital. In addition, the share targeted by the option would have to be in a class of shares listed on a Canadian stock exchange or a foreign stock exchange recognized for Canadian taxation purposes. The exercise price must also be at least equal to the difference between the amount paid by the employee to acquire the option, if any, and the market value of the share targeted when the option was granted.

The taxable benefit which can be deferred by an employee is subject to an annual limit. The tax deferral is available only if the specified value of the particular share does not exceed $100,000. The terms and conditions of this limit are not precisely set forth in the budget documents. We will have to wait the legal particulars before defining with certainty all details pertaining to this limit.

It has to be noted that the Québec Minister of Finance announced in his March 14, 2000 Budget Speech that the Québec legislation would be harmonized to the previous analysed modifications.

The flexibilities introduced by the tax authorities in the tax treatment of stock options will probably increase the popularity of this type of compensation in the years to come. Some questions should be emphasized though, specifically on the fact that only CCPC and public corporations employees seem to benefit from this tax deferral. We can wonder why employees of a corporation which does not qualify as a CCPC or a public corporation, for example a corporation controlled directly or indirectly by a public corporation, cannot benefit from the same tax deferral. As indicated above, these questions will probably be answered in part by the legislation on the measures introduced.

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Capital Gain rollover for investment in small business

Most small business owners know the challenges associated with raising capital for their companies in order to foster growth. Over the years, various Finance ministers have innovated by creating mechanisms which, by the use of tax incentives, have tried to encourage investors to put their money into small and medium size businesses. This year, the Federal Finance Minister has announced a new plan which will allow individuals, other than trusts, to defer paying tax on capital gains realized after February 27, 2000 from the disposition of small business investments provided that the proceeds from the disposition of their small business investments are reinvested in common shares issued from Treasury of another eligible small business. The Quebec Finance Minister announced during his Budget Speech presented on March 14, 2000 that the Quebec Tax legislation would be amended in order to follow the change proposed by the Federal Finance Minister.

The capital gain eligible for the deferral will depend on the percentage of the proceeds of disposition reinvested, not the capital gain itself which is reinvested.

The capital gain which can be deferred is not limited in its magnitude other than by reference to the adjusted cost base of the shares which are disposed of by the individual. The original cost of the shares disposed of must not exceed $500,000, failing which the capital gain which can be deferred will be pro-rated as a percentage of the $500,000. Provided the $500,000 adjusted cost base condition is met, there is no limit to the amount of the gain which can be deferred. Thus if an individual sells shares for 2 million dollars, the whole gain can be deferred, if properly re-invested, provided the adjusted cost base of the shares sold does not exceed $500,000. If the shares sold for $2 million dollars had a $ 1 million dollar cost base, then only 50% of the capital gain realized is eligible to be deferred (i.e. $500,000/$1,000,000 = 50%).

For a capital gain to be deferred, it must be invested within a set period of time into shares of a new eligible business. However, a maximum of $500,000 can be invested into any new eligible business or related businesses by any individual for the deferral to apply. An individual can invest in any number of new eligible businesses for the deferral to apply provided that the total invested in any one business and related businesses does not exceed $500,000. Thus, if we take the case of an individual who has realized a $1.5 million dollar capital gain by selling shares which cost him $500,000 for $2 million, this individual could defer the

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entire gain provided he re-invested $2 million into at least four separate non-related eligible businesses, with no more than $500,000 being invested into each such business.

The deferral essentially works by reducing the adjusted cost base of the shares acquired in the new eligible business by the eligible deferral amount. The amount of the deferral depends on three factors. Firstly, the percentage of the proceeds of disposition reinvested; secondly, as a function of the adjusted cost base of the shares which were disposed of and which generated the capital gain; and lastly by the amount reinvested into new eligible businesses.

When an individual disposes of shares of an eligible business in a taxation year, he may benefit from the deferral only if amounts are reinvested after the beginning of the taxation year in which the gain was realized and no later than the earlier of the 120th day following the disposition which triggers the capital gain and the 60th day after the end of the year in which the capital gain occurred.

To qualify as an eligible corporation, the corporation into which the subsequent investment is made must meet certain criteria. The corporation must be a Canadian-controlled private corporation, all or substantially all of the assets of which (generally interpreted as meaning at least 90%), as measured by fair market value, are used in an active business carried on primarily in Canada (generally interpreted as meaning at least 50%).

For shares of a corporation to qualify as an eligible corporation, the total carrying value of the assets of the corporation and related corporations must not exceed $2.5 million immediately before the investment is made, nor must it exceed $10 million immediately after the investment.

Finally throughout the period of time during which the individual owns the shares, the corporation must be a taxable Canadian corporation which will be required to use all or substantially all of its assets (over 90%), as measured by fair market value, in an active business carried on primarily (over 50%) in Canada. This means that an investment made in shares of a private corporation can still qualify for the deferral after the corporation has become a public corporation provided the corporation meets the other tests.

It would appear that shares held by an individual through a qualifying pooling arrangement will also qualify for the new deferral rules. These will be special purpose partnerships which will act as an agent for a number of investors. The Federal Minister of Finance has begun a consultation period to see what type of pooling arrangements should qualify. Whether directly or through such a qualifying pooling arrangement, the shares will have to be held for a minimum of 6 months in order to qualify for the capital gain deferral rules.

The general framework for the new program was outlined in the February 28, 2000 Budget Speech, however the details will not be known until a Draft Bill is tabled in The House of Commons spelling out the particulars. There is no doubt that these new rules will be most beneficial to those taxpayers who have exhausted their lifetime capital gains exemption and who are selling shares of other eligible small business investments and who wish to continue to invest in small and medium size businesses. This new measure will allow individual to have roughly an extra 35% of their capital working for them by deferring the tax on the capital gain as opposed to paying the amounts immediately as capital gains taxes.

As the budget only outlined the general principles and not the detailed rules, it is safest to reproduce the examples outlined therein to illustrate the workings of the new provisions as opposed to making up our own examples.

Example 1

On March 31, 2000, Harold sells his shares in Corporation A which are eligible small business investments. His proceeds of disposition are $100,000 and his capital gain is $60,000. On July 1, 2000, Harold invests $90,000 in shares of Corporation B which are new eligible small business investments.

Since Harold reinvests only nine tenths of the proceeds in replacement small business investments, he can defer only nine tenths of the gain ($54,000). He therefore has a $6,000 capital gain from the disposition for the year.

Harold's adjusted cost base of the Corporation B shares is reduced from $90,000 to $36,000 because of the capital gains deferral of $54,000.

Example 2

On November 30, 2000, Kate disposes of shares in Corporation C which are eligible small business investments. Her proceeds of disposition are $1,000,000 and she realizes a capital gain of $600,000. On February 1, 2001, Kate acquires shares in Corporation D at a cost of $1,000,000 which are new eligible small business investments.

Since the investment limit in respect of a corporation or a related group of corporations is $500,000, Kate can defer capital gains on up to one half of her eligible capital gains of $600,000 (i.e. $300,000). After the deferral, she has a capital gain from the disposition for the year of $300,000.

Kate's adjusted cost base of the Corporation D shares is reduced by the $300,000 deferred gain, from $1,000,000 to $700,000.

If Kate had instead reinvested $500,000 each in shares of two unrelated corporations that were eligible small business investments, she would have been able to defer all of the $600,000 eligible gain. In this case, the adjusted cost base of each of the two new investments would have been reduced by $300,000.

Example 3

Robert has shares in Corporation X which are eligible small business investments having an adjusted cost base of $1,000,000. He sells the shares for proceeds of disposition of $3,000,000 and realizes a capital gain of $2,000,000. Because of the $500,000 investment limit, only the capital gains relating to $500,000 of the original investment are eligible for a deferral. Robert purchases replacement eligible small business investments in six other unrelated corporation of $500,000 each for a total reinvestment of $3,000,000.

While Robert's cost of the replacement eligible small business investment is $3,000,000, the maximum amount he can use to calculate his capital gains deferral is $1,500,000, which is equal to the proceeds of disposition that relate to the eligible gain.

The maximum capital gains deferral that Robert can claim is $1,000,000.

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