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Transalta - a planning opportunity

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Under Canadian tax law, a corporate tax deduction is not permitted where awards issued under an agreement to sell or issue shares to employees are satisfied by an employer corporation distributing treasury or newly issued securities. Where an award provides an employer with the discretion to settle an award either in shares or cash, the issue is whether an agreement to issue shares arises at the time the employer decides to settle the awards in shares. The longstanding position of the Canada Revenue Agency (CRA) is that where an employer elects to settle awards in shares, an agreement to issue securities will arise at the point the employer decides to settle the award in shares; therefore, a corporate deduction will be denied. However, this position was rejected in the recent case of *Transalta Corp. v. R.*[1] The CRA has not appealed the decision.

The *Transalta* case will provide welcome tax relief for employers, particularly foreign employers with experience in other jurisdictions where a deduction for share-settled awards can be claimed. However, the limitations of the case must be recognized. Further, it may create concerns for some employers.

In this case, the employer had established a three-year deferred bonus plan. At the end of the performance period, the employer decided the amount that the employees would receive and whether the bonus will be settled in cash or shares. In some years, the employer settled the bonus by issuing shares. The question before the court was whether section 7 of the Income Tax Act (the Act) operated to deny the employer's Canadian tax deduction in those circumstances on the basis that Transalta had agreed to issue securities to employees.

The court held that the employer had not created a legally binding agreement to issue shares, as required by section 7 of the Act, either when the awards were made or at the time the employer decided to issue shares, as the employer was able to decide up until the time of settlement whether to settle the awards in cash or shares.

Further, the court rejected the argument that the employer could not deduct the share-settled bonuses because it had not incurred an expense. The court noted that Transalta's stated capital had increased, and accepted that the shares were issued in consideration for past services and not as a result of the release of any accrued liability to the participants. In determining the amount deductible, the court looked to the governing corporate legislation in determining that the value of the services rendered must at least equal the value of the shares issued.

[1] 2012 TCC 86, [2012] 3 C.T.C. 2186, 2012 D.T.C. 1106 (Tax Court of Canada).

Implication of the decision

Since the decision may permit companies to deduct the cost of shares used to settle stock awards, it provides support for companies seeking to preserve working capital. Further, it would enable U.S. and other foreign parent companies to replicate their country's deduction when shares are issued to Canadian employees under a restricted stock unit plan. In addition, the decision supports the position that the amounts paid under a recharge agreement to a U.S. parent company that issues shares under a similar plan should be deductible by the Canadian subsidiary. Further, the risk that the payments to the foreign parent would be characterized as a shareholder benefit, and thus subject to non-resident dividend withholding tax, should be mitigated.

While the court did not comment on the application of proposed section 143.3 of the Act, which proposes to limit the corporate deduction in the case of section 7 awards, the court holding should still stand after the enactment of section 143.3, given the current wording of the proposed legislation.

However, employers should be aware of the potential tax consequences for employees being granted non-section 7 awards, namely that such plans must be structured to avoid the application of the salary deferral arrangement (SDA) rules, which would otherwise result in accelerated taxation to employees. The most practical method of mitigating the SDA risk for bonus-type plans is to ensure that all payments are made no later than December 31 of the third year following the year in which the services giving rise to the award were rendered.

Transalta also creates concern regarding the situation where a Canadian controlled private corporation (CCPC) has adopted an informal approach to the issuance of shares to employees. In an appropriately structured arrangement, the benefit arising from the grant of CCPC shares will not be taxed in the hands of the employee until the shares are sold. Further, the benefit may be taxed at a preferential rate if the employee retains the shares for at least two years after the date of issuance. Following the *Transalta* case, it is not clear that an ad hoc decision by the board to issue shares to selected employees in lieu of a cash bonus will create the valid "agreement to issue securities" on which the employee's preferential tax treatment is premised. As a result, we recommend that in order to avoid this issue, CCPC employers should implement a formal stock award plan and establish a formal award process.

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