TAXADVISOR

Taking Stock

Option grants count as income

TAX COURT

BY JAMIE GOLOMBEK

Employees who participate in employee stock purchase plans (ESPPs) or exercise employee stock options only to find the price of the shares plummet thereafter are left with a potentially explosive tax problem.

That's because, under Canadian tax law, if you purchase shares through either an ESPP or by exercising an employee stock option, your taxable employment benefit (and thus your tax liability) is based on the difference between the price you paid for the shares and the fair market value of shares on the date you receive them. While the value of the taxable benefit is fixed when the shares are acquired, the benefit can generally be deferred until the year you sell the shares.

Therein lies the problem: suppose the shares have subsequently declined in value between the date you received them and the time you ultimately sell them. The resulting loss is considered to be a "capital loss," which can only be used to offset capital gains and cannot be deducted against the taxable employment benefit that arose upon acquiring the shares.

It is this mismatch of capital loss against employment income that has created the harsh economic reality for employees who face massive tax bills on money they never "received."

While a remission order was granted late last year forgiving both the income taxes and arrears interest of 35 ex-employees of SDL Optics Inc. that arose from participation in their employer's stock purchase plan, whose shares subsequently plummeted, that order only applies to them. What about the estimated tens of thousands of other Canadians in these situations? A tax case decided in late February (*Howard v. The Queen*, 2008 TCC 51) may offer a glimmer of hope.

David Howard, a chartered accountant, was employed as a vice-president and chief financial officer with Cell-Loc Inc. from May 1999 to December 2000, through both the height and subsequent meltdown of the technology bubble. Howard received stock options as part of his remuneration. He was unable to sell the shares because of a trading blackout as an insider. He was also encouraged to hang on to his share position "in order to communicate confidence to the marketplace."

On December 13, 2000, Howard lost his job. He immediately sold all his Cell-Loc shares, and subsequently reported a capital loss of about $800,000 on his 2000 tax return in respect of the disposition of those shares.

In late February of 2000, Howard received his T4 from Cell-Loc, showing a large stock benefit Howard needed to claim on his return. After being assessed for the tax owing on the exercise of stock options, Howard sought professional tax advice and hired KPMG to refile his 2000 return to report his Cell-Loc stock losses as an "income loss" rather than a capital loss.

Not surprisingly, the CRA refused to recharacterize the loss as an income loss.

In court, Howard took the position that he was a "trader or dealer" in the business of selling Cell-Loc shares and thus his loss should be considered a fully tax-deductible business loss as opposed to a capital loss, which would not have been otherwise deductible against his stock option employment taxable benefit.

As discussed in AER's March 2008 column (*Accounting for Gains*), the issue of "income vs. capital" comes up regularly; the court generally looks to a number of factors in determining the appropriate tax treatment. These factors include: the frequency of transactions, the length of the holdings, the intention to acquire for resale at a profit, the nature and quantity of the securities held and the time spent on the activity.

The judge weighed the above factors and concluded that the evidence "was consistent with [Howard's]… stated intention of acquiring the shares to resell for profit at the earliest best opportunity." Howard's share activities in 2000 thus amounted to those of a "'trader or dealer' in the business of selling his Cell-Loc shares" and thus Howard was allowed to claim the loss as a business loss on his 2000 return. **AER**

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More to Joint Ownership

Ignore bad advice: such as just add a name when transferring assets

BY ARTHUR J. FISH AND RICHARD E. AUSTIN

Older Canadians are increasingly being advised to transfer assets to their children by making them joint owners of bank or brokerage accounts. This is often bad advice. Merely adding an additional name as co-owner to an existing account is generally not enough. Advisors must take care to ensure that they have created the kind of joint ownership their client really intends. Put simply, joint ownership is not simple.

DEFINE JOINT OWNERSHIP

Joint ownership is a legal arrangement under which more than one person has ownership rights in a particular asset, such as a bank or brokerage account. The joint owners own the entire asset together, so that neither of them may alone assert rights to any particular part of the asset. For example, Joe and his adult son, James, are joint owners of a brokerage account, the sole asset of which is 50 shares of A Co. You might think that Joe owns 25 of those shares, and James the other 25 – in fact, each owns all 50 shares.

HOW TO CREATE IT

Joint ownerships are most commonly created by gifting, often from a parent to a child. Typically, the parent alone owns an asset and decides to add a child as a joint owner. Usually, the parent intends to own and control the asset while alive and to leave it to his or her child on death. While the arrangement is not intended to be effective immediately, parents often fail to appreciate that granting joint ownership involpves an immediate transfer of rights to the child – putting an asset into joint ownership is a form of gifting, and Canadian law requires a fairly high level of proof to establish that a parent intended to gift assets to an adult child.

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People often wrongly assume that merely adding a child's name to a bank or brokerage account form is enough to ensure that the child will own the asset when the parent dies. To make certain that a joint ownership is actually created, it is necessary to clearly document both that the parent intends to gift an interest in an asset to his or her child and the precise nature of the interest in the asset gifted.

In two recent cases, the Supreme Court of Canada has confirmed that the law presumes that a parent who adds a child's name to a brokerage account does not intend to have that child be the sole owner of the gifted asset when the parent dies. Rather, the law will presume that the parent intended, at most, to give the child some kind of decision-making authority over the asset. In technical terms, when a parent makes a gift to an adult child, the law will presume that there is a "resulting trust" for the parent's benefit. The following hypothetical scenario shows how these rules can work in practice to frustrate a client's wishes.

Joe is an 84-year-old widower with three adult children. He lives in Ontario and has been advised that when he dies, his estate will have to pay probate fees of 1.5% of the value of the shares in his brokerage account. He is also told that he can avoid paying these probate fees by putting his shares in joint ownership with one or more of his children, because when one joint owner dies, the other automatically becomes the sole owner of the shares.

Joe's will leaves his estate in equal shares to his son, James, and his daughters, Gretchen and Gertrude. But James has spent many hours helping Joe maintain his home, so Joe decides that he will leave his brokerage account to James alone. Joe instructs his financial advisor to re-register the account in joint names. The advisor has Joe and James sign a new account form simply describing Joe and James as joint owners, and continues to take instructions from Joe alone. Only Joe benefits from the assets in the account, and only he declares any income or gains from the account and pays the resulting taxes. When Joe dies, James's sisters initiate a lawsuit, claiming that the account should become part of Joe's estate. Gretchen and Gertrude win their lawsuit because the judge decides that merely changing the names on the brokerage account was not enough to prove that Joe intended that James alone would inherit the shares.

DIFFERENT KINDS

It is important to note that the legal rules we have described are merely presumptions. They do not forbid a parent to gift assets to an adult child; they merely require that the parent take steps to demonstrate that he or she unmistakably intended to gift rights to property. In Joe's case, there are various steps that could have been taken to ensure that James alone would have been entitled to the shares.

Legal advice: Joe could and should have been referred to his own lawyer for advice before giving away a valuable asset to his child. This is a helpful step for three reasons. First, because a lawyer would have explained to Joe the implications of giving away his asset. Second, because the involvement of an independent lawyer would help to establish that Joe really intended to make the gift and was not being pressured by a third party to do so. And, finally, because the lawyer could have more fully and carefully documented Joe's intentions.

Clear documentation: Even if it was impossible or impractical for Joe to seek legal advice, he could still have been invited to document his wishes in writing. Instead of merely creating a new account form, Joe could have indicated in writing that he intended to gift an interest in his account and understood the implications of what he was doing.

What kind of joint ownership: Recent Supreme Court of Canada decisions have clarified that joint ownership can mean at least three different things:

- Full or true joint ownership
- Joint control with no right of survivorship
- Right of survivorship but no control

With full joint ownership, there is an immediate gift of ownership. Each owner is entitled to share in profits and is obligated to report any taxable income or gains derived from the property. Both have the right to issue instructions on the use of the asset (e.g., on buying or selling stocks in a brokerage account). Each owner has a right of survivorship with respect to the other, which means that if one owner dies, the other automatically owns the asset.

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