

March 4, 2005

Une version de ce numéro d'Actualités Osler est disponible en français sur notre site [Web osler.com](http://Web.osler.com)

Hemant Tilak  
(416) 862-6400  
[htilak@osler.com](mailto:htilak@osler.com)

Dov Begun  
(416) 862-6571  
[dbegun@osler.com](mailto:dbegun@osler.com)

Mark Brender  
(514) 904-5777  
[mbrender@osler.com](mailto:mbrender@osler.com)

Stan Ebel  
(403) 260-7051  
[sebel@osler.com](mailto:sebel@osler.com)

## Canada's Tax Court Finds Stock Option Benefits Are Qualified Expenditures For Investment Tax Credits

Depending upon the outcome of any appeal, stock option benefits conferred on employees by taxpayers engaged in scientific research and experimental development (or SR&ED) activities in Canada may qualify for investment tax credits (or ITCs).

In last week's decision in *Alcatel Canada Inc. v. Her Majesty the Queen*, the Tax Court of Canada held that employee stock option benefits, although not deductible for Canadian income tax purposes, were expenditures of the employer that qualified for ITCs under Canada's *Income Tax Act*.

The Crown has until the last week of this month to appeal the decision. Taxpayers engaged in SR&ED activities in Canada should consider taking steps to preserve their rights to claim ITCs in respect of stock option benefits (or other non-cash items) pending the outcome of any appeal.

### The Stock Option Program

Newbridge Networks Corporation, the predecessor of Alcatel Canada Inc., had established an employee stock option program under which employees who were engaged in SR&ED activities in Canada were granted options to purchase a specified number of common shares of Newbridge at an exercise price equal to their market value at the time of the grant. Common shares of Newbridge were traded in the stock markets. Upon exercising options, employees benefited from increases in the market value of the shares without any cash outlay by Newbridge.

The issue in *Alcatel* was whether the stock option benefits realized on options exercised in 1994 by employees were current expenditures incurred by

Newbridge for employee compensation for the year in which the options were exercised. If they were, Newbridge would be entitled to ITCs on such expenditures.

### Positions Taken

Alcatel argued that Newbridge incurred an expense at the time of exercise because it became liable at that time to issue shares for an exercise price that was less than the market value of the shares at that time. Alcatel also argued that, because the purpose of the stock option program was to compensate employees and not to raise capital by issuing shares, the expense was a current expense and was not on capital account.

The Crown argued that Newbridge made no outlay on the exercise of options and there was, therefore, no expenditure by it. In any case, the Crown argued, any expenditure made by Newbridge was on capital account because there was an increase in the company's capital when shares were issued on the exercise of options and any expenditure arose from a distribution of shares that generated capital (and not from ordinary revenue generating activities).

### Lowry Decision Rejected

The cornerstone of the Crown's case was the 1940 decision of the U.K. House of Lords in *Lowry v. Consolidated African Selection Trust*, also a case in which a corporation granted its employees the

right to purchase its shares at par (when their market value was higher) as compensation for services rendered by its employees. There, the House of Lords had held that the corporation could not deduct from its profits the premium it would have received had the shares been issued in the open market for their market value.

The Tax Court concluded that, although a decision of the House of Lords was entitled to great respect, *Lowry* was not binding on the courts in Canada. The court reasoned that *Lowry* did not consider the meaning of “expenditure” in the context of a statutory scheme intended to encourage SR&ED activities and, unlike in *Lowry*, the facts in *Alcatel* did not support a conclusion that the cost of the stock option benefits was on capital account.

## Ordinary Meaning Prevails

The Tax Court noted that the meaning of “expenditure,” which was implicit in *Lowry*, was not the same as the ordinary meaning today (which is found in dictionary definitions of the word). Today’s meaning of “expenditure” is not confined to outlays of cash or other property. For example, the court noted, the Canadian government uses the words “tax expenditures” to refer to tax revenues foregone under statutory exemptions, deductions and similar provisions that reduce the tax that would otherwise be payable.

In the Tax Court’s view, “a very real expenditure is accomplished when shares having an established market value are sold for less than that value in the context of a scheme for the compensation of the employees who buy them.” Moreover, stock option benefits are included in “salary or wages” as defined

in the Act and, in the court’s view, it was “hard to see how salary or wages can flow from employer to employee without expenditure on the part of the employer.”

## Crown’s Other Arguments Rejected

Having concluded that Newbridge had made an expenditure in respect of stock option benefits, the Tax Court addressed other arguments of the Crown. It dismissed the Crown’s argument that the expenditures made by Newbridge were on capital account. The expenditure was of a current nature because the primary purpose of the stock option program was neither to raise capital (which was an incidental result) nor to affect Newbridge’s capital structure but to satisfy a recurring need to compensate employees engaged in the daily business operations.

It was not determinative, in the Tax Court’s view, that accounting principles (which have now changed) did not require an expense to be reflected in the financial statements for the relevant years for the stock options or benefits. That did not reflect the reality that the expenditures were made by Newbridge to earn its income. And, the court held, the statutory rule denying a deduction for the expenditures in computing income for tax purposes did not affect the computation of ITCs.

## Looking Ahead

It is not known whether the Crown will appeal the decision of the Tax Court. Taxpayers engaged in SR&ED activities in Canada should consider taking steps to preserve their rights to claim ITCs in respect of stock option benefits (or other non-cash items) pending the outcome of any appeal.

---

*This Osler Update is available in the Publications section of osler.com. This memorandum is a general overview of the subject matter and cannot be regarded as legal advice. Subscribe to a full range of updates at osler.com. You can unsubscribe at any time at osler.com or <http://unsubscribe.osler.com>. © Osler, Hoskin & Harcourt LLP, 2005*

**OSLER,  
HOSKIN &  
HARCOURT**

Osler, Hoskin & Harcourt LLP

**osler.com**

e-mail: [counsel@osler.com](mailto:counsel@osler.com)

**TORONTO**  
P.O. Box 50  
1 First Canadian Place  
Toronto, Ontario M5X 1B8  
Tel. 416.362.2111  
Fax. 416.862.6666

**MONTRÉAL**  
1000 de La Gauchetière Street West  
Suite 2100  
Montréal, Québec H3B 4W5  
Tel. 514.904.8100  
Fax. 514.904.8101

**OTTAWA**  
Suite 1500  
50 O’Connor Street  
Ottawa, Ontario K1P 6L2  
Tel. 613.235.7234  
Fax. 613.235.2867

**CALGARY**  
Suite 1900  
Toronto Dominion Square  
333 – 7th Avenue S.W.  
Calgary, Alberta T2P 2Z1  
Tel. 403.260.7000  
Fax. 403.260.7024

**NEW YORK**  
280 Park Avenue – 30W  
New York, New York  
U.S.A. 10017  
Tel. 212.867.5800  
Fax. 212.867.5802