Docket: 2012-1230(IT)G

BETWEEN:

DONALD FETTES,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on June 17, 2015, at Saskatoon, Saskatchewan

By: The Honourable Justice Campbell J. Miller

Appearances:

Counsel for the Appellant:	T. John Agioritis
Counsel for the Respondent:	John Krowina

JUDGMENT

The Appeal from the reassessment made under the *Income Tax Act* for the 2008 taxation year is dismissed with costs to the Respondent.

Signed at Ottawa, Canada, this 6th day of August 2015.

"Campbell J. Miller"

C. Miller J.

Citation: 2015 TCC 198
Date: 20150806
Docket: 2012-1230(IT)G

BETWEEN:

DONALD FETTES,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

C. Miller J.

[1] Mr. Donald Fettes was an employee of USFWatergroup, Inc., later known as Watergroup Companies Inc. He was granted stock options for shares in a related company, Culligan Ltd., on December 30, 2004 and February 10, 2005. In these two Option Agreements the option price was $10 per share for 10,000 shares and 45,000 shares respectively, valued at that time at the same $10 per share. In 2008, Mr. Fettes exercised options for 41,250 shares that had vested at an exercise or strike price of $2.02 per share: the shares had a fair market value at that time of $8.05. The Minister of National Revenue (the "Minister") applied section 7 of the *Income Tax Act* (the "*Act*") to bring into Mr. Fettes' 2008 income, as a benefit of employment, an amount substantially equal to the value of the shares less the amount paid for them ($8.05 - $2.02). No amount was deducted from income pursuant to paragraph 110(1)(*d*) of the *Act*. Mr. Fettes appeals on the basis that he is entitled to a deduction, pursuant to paragraph 110(1)(*d*) of the *Act* in 2008 of half the benefit brought into income, because he met the three requirements of that paragraph:

i. The shares were common shares.
ii. He was at arm's length with his employer and the issuer of the shares.
iii. The amount payable under the option agreement was not less than the fair market value of the shares at the time the agreements were made.

[2] The Respondent concedes the first two points but argues that because the exercise or strike price was reduced to $2.02 from $10.00, Mr. Fettes does not meet this third requirement.

[3] Initially this case raised a number of issues but the above is a distillation of where the Parties were left at trial. I am therefore only going to review those facts that relate directly to the sole issue of whether the circumstances of Mr. Fettes' options meet the requirements in paragraph 110(1)(*d*) of the *Act*, in particular that the amount payable by Mr. Fettes to acquire the shares under the agreement is not less than the fair market value of the shares at the time the agreement was made.

[4] Mr. Fettes was, in 2004 and until dismissed in 2008, an executive of Watergroup Companies Inc. governed by an employment agreement of September 30, 1997 between himself and what was then known as USFWatergroup, Inc. I will simply refer to the Watergroup companies as ("Watergroup"). Through various acquisitions and changes of control since 1998, by 2004 Watergroup was a subsidiary of Culligan of Canada Ltd., part of the Culligan group of companies, including a Bermuda company, Culligan Ltd. The Culligan companies, like Watergroup, were in the water treatment related business, though operated as separate businesses. Culligan Ltd. and Watergroup did not deal at arm's length.

[5] Mr. Fettes provided advice to the Culligan group. He was invited to acquire 5,000 Culligan Ltd. common shares, and flowing from that, to participate in the Culligan Ltd. Stock Incentive Plan.

[6] Pursuant to an Employee Stock Option Plan entered on December 30, 2004, Culligan Ltd. granted Mr. Fettes an option to purchase 10,000 common shares of Culligan Ltd. for an exercise price of $10 per share. Similarly, on February 10, 2005, there was a further grant of an option of 45,000 common shares at $10 per share. Pursuant to these agreements the shares would vest over a four year period in four equal instalments. The fair market value of the shares at the time of these agreements was $10 per share. By August 8, 41,250 option shares had vested.

[7] Mr. Fettes' counsel stressed the importance of section 4 of the Employee Stock Option Agreement so I will reproduce portions of it:

> (a) General. Subject to such reasonable administrative regulations as the Board may adopt from time to time, the Employee may exercise vested Options by giving at least 15 business days prior written notice to the Secretary of the Company specifying the proposed date on which the Employee desires to exercise a vested Option (the "Exercise Date"), the number of whole shares

> with respect to which the Options are being exercised (the "Exercise Shares") and the aggregate Option Price for such Exercise Shares (the "Exercise Price"); … Unless otherwise determined by the Board, and subject to such other terms, representations and warranties as may be provided for in the Employee Stock Subscription Agreement, (i) on or before the Exercise Date the Employee shall deliver to the Company full payment for the Exercise Shares in United States dollars in cash, or cash equivalents satisfactory to the Company, in an amount equal to the Exercise Price plus any required withholding taxes or other similar taxes, charges or fees and (ii) the Company shall register the issuance of the Exercise Shares in the name of the Voting Trustee, pursuant to the Voting Trust Agreement, on its records (or direct such issuance to be registered by the Company's transfer agent).

[8] Mr. Fettes' employment with Watergroup was terminated on July 15, 2008, effective August 1, 2008. He was advised by Mr. Seales, the CEO, by letter of July 15, 2008, that the company would assist Mr. Fettes in exercising his vested options to buy shares. This letter was followed by an email from a paralegal with Culligan, Amy McLean, attaching an Option Exercise Stock Subscription Agreement, setting out the withholding calculations and requesting a cheque for $46,866.02 U.S. (representing an exercise price of $2.02 per share for 23,201.01 shares). This arises from the following withholding calculation provided by Ms. McLean:

Culligan Ltd.
Withholding Analysis on Options

41,250 Options * $8.05 - $2.02 = 248,737.50

		Withholding Taxes						
Income	**Federal**	**Province**	**CPP**	**EI**	**Total**	**Share Price**	**# of Shares**	**Net Shares Issued**
248,737.50	71,690.44	37,144.99	-	-	108,835.43	8.05	18,048.99	
248,737.50	71,690.44	37,144.99	-	-	108,835.43		18,048.99	23,201.01

[9] In considering exercising the options, Mr. Fettes requested some information from Culligan and was provided with a sheet called Culligan Ltd. Stock Incentive Plan – Equity Summary – Example, which I attach as Schedule A to these Reasons.

[10] I note in the bottom chart of the attached Schedule A that on May 28, 2007, the strike price was shown as $2.02, presumably having fallen to that amount due to the effect of what the chart shows as a cash bonus paid on that date. Mr. Fettes,

the only witness, could offer no explanation regarding the circumstances surrounding this reduction in the exercise price established in the original Stock Option Agreements. He paid the $46,866.02 U.S. requested, exercising his options.

[11] Mr. Fettes signed the Option Exercise Stock Subscription Agreement in September 2008, though never received a signed copy back from Culligan Ltd. This Agreement stipulated in Section 1 (a):

> In General. Subject to all of the terms of this Agreement, at the Closing, the Former Employee shall purchase, and the Company shall sell, the aggregate number of Common Shares set forth on the signature page hereof (the "Shares"), at a purchase price of $2.02 per Share, pursuant to the Former Employee's exercise of Options.

[12] The Agreement also stipulated the shares could not be sold back to the company for at least six months. In early 2009, Mr. Fettes did sell the 23,201 shares back to the company for $5.00 per share, reflected in section 2 of a Stock Purchase Agreement:

> Share Purchase Price. The Company and the Stockholder agree that the purchase price for the Shares shall be US $116,005.00 (the "Purchase Price"). The Company and the Stockholder acknowledge and agree that the Purchase Price is equal to the number of Shares multiplied by their Fair Market Value of $5.00 per Share (as defined in the Culligan Ltd. Stock Incentive Plan) as of the date of this Agreement.

[13] Mr. Fettes testified that after his termination in 2008 his relationship with Culligan and Watergroup deteriorated significantly: lengthy litigation ensued. In early 2009, Mr. Fettes received a T4 from Watergroup setting out his remuneration including his salary and a severance payment of $458,856. There was no mention of any benefit arising from the exercise of the options. The Respondent provided an affidavit of a Canada Revenue Agency ("CRA") officer attaching a copy of a CRA screen print out indicating an amended T4 had been received from Watergroup, and that Mr. Fettes' income was $692,620 ($233,764 greater than the original T4). Mr. Fettes never received a copy of an amended T4.

[14] On examination for discoveries the Respondent's representative indicated that no paragraph 110(1)(*d*) of the *Act* deduction was provided as the amended T4 did not report Mr. Fettes' entitlement to such in box 39 of the T4 form.

Legislation

[15] Parts of Section 7 of the *Act* read as follows:

> (1) Subject to subsection (1.1), where a particular qualifying person has agreed to sell or issue securities of the particular qualifying person (or of a qualifying person with which the particular qualifying person does not deal at arm's length) to an employee of the particular qualifying person (or of a qualifying person with which the particular qualifying person does not deal at arm's length),
>
> (a) if the employee has acquired securities under the agreement, a benefit equal to the amount, if any, by which
>
> (i) the value of the securities at the time the employee acquired them
>
> exceeds the total of
>
> (ii) the amount paid or to be paid to the particular qualifying person by the employee for the securities, and
>
> (iii) the amount, if any, paid by the employee to acquire the right to acquire the securities
>
> is deemed to have been received, in the taxation year in which the employee acquired the securities, by the employee because of the employee's employment;
>
> …
>
> (1.4) Where
>
> (a) a taxpayer disposes of rights under an agreement referred to in subsection (1) to acquire securities of a particular qualifying person that made the agreement or of a qualifying person with which it does not deal at arm's length (which rights and securities are referred to in this subsection as the "exchanged option" and the "old securities", respectively),
>
> (b) the taxpayer receives no consideration for the disposition of the exchanged option other than rights under an agreement with a person (in this subsection referred to as the "designated person") that is
>
> (i) the particular person,
>
> (ii) a qualifying person with which the particular person does not deal at arm's length immediately after the disposition,
>
> (iii) a corporation formed on the amalgamation or merger of the particular person and one or more other corporations,

(iv) a mutual fund trust to which the particular person has transferred property in circumstances to which subsection 132.2(1) applied,

(v) a qualifying person with which the corporation referred to in subparagraph (iii) does not deal at arm's length immediately after the disposition, or

(vi) if the disposition is before 2013 and the old securities were equity in a SIFT wind-up entity that was at the time of the disposition a mutual fund trust, a SIFT wind-up corporation in respect of the SIFT wind-up entity

to acquire securities of the designated person or a qualifying person with which the designated person does not deal at arm's length (which rights and securities are referred to in this subsection as the "new option" and the "new securities", respectively), and

(c) the amount, if any, by which

(i) the total value of the new securities immediately after the disposition

exceeds

(ii) the total amount payable by the taxpayer to acquire the new securities under the new option

does not exceed the amount, if any, by which

(iii) the total value of the old securities immediately before the disposition

exceeds

(iv) the amount payable by the taxpayer to acquire the old securities under the exchanged option,

for the purposes of this section,

(d) the taxpayer is deemed (other than for the purposes of subparagraph (9)(d)(ii)) not to have disposed of the exchanged option and not to have acquired the new option,

(e) the new option is deemed to be the same option as, and a continuation of, the exchanged option, and

(f) if the designated person is not the particular person, the designated person is deemed to be the same person as, and a continuation of, the particular person.

…

[16] At the relevant time subparagraphs 110(1)(*d*)(i) and (ii) of the *Act* read:

110(1) For the purpose of computing the taxable income of a taxpayer for a taxation year, there may be deducted such of the following amounts as are applicable

(d) an amount equal to 1/2 of the amount of the benefit deemed by subsection 7(1) to have been received by the taxpayer in the year in respect of a security that a particular qualifying person has agreed after February 15, 1984 to sell or issue under an agreement, or in respect of the transfer or other disposition of rights under the agreement, if

(i) the security

(A) is a prescribed share at the time of its sale or issue, as the case may be,

(B) would have been a prescribed share if it were issued or sold to the taxpayer at the time the taxpayer disposed of rights under the agreement,

(C) would have been a unit of a mutual fund trust at the time of its sale or issue if those units issued by the trust that were not identical to the security had not been issued, or

(D) would have been a unit of a mutual fund trust if

(I) it were issued or sold to the taxpayer at the time the taxpayer disposed of rights under the agreement, and

(II) those units issued by the trust that were not identical to the security had not been issued,

(ii) where rights under the agreement were not acquired by the taxpayer as a result of a disposition of rights to which subsection 7(1.4) applied,

(A) the amount payable by the taxpayer to acquire the security under the agreement is not less than the amount by which

(I) the fair market value of the security at the time the agreement was made

exceeds

(II) the amount, if any, paid by the taxpayer to acquire the right to acquire the security, and

(B) at the time immediately after the agreement was made, the taxpayer was dealing at arm's length with

(I) the particular qualifying person,

(II) each other qualifying person that, at the time, was an employer of the taxpayer and was not dealing at arm's length with the particular qualifying person, and

(III) the qualifying person of which the taxpayer had, under the agreement, a right to acquire a security, and

…

Issue

[17] Is Mr. Fettes entitled to a deduction pursuant to paragraph 110(1)(*d*) of the *Act*, specifically, was the amount payable by him to acquire the shares under the agreement not less than the fair market value of the shares at the time the agreement was made? So, what was the amount payable by Mr. Fettes to acquire the shares under the agreement: if it was $10 per share he is eligible for the paragraph 110(1)(*d*) of the *Act* deduction; if it was $2.02 per share he is not eligible for the deduction.

[18] Mr. Fettes' counsel argues I can only look to the original agreement which stated the option price was $10. The Respondent's counsel argues that the agreement was amended to reflect an option price of $2.02 and that was the amount payable under the agreement.

[19] I had asked the Parties to consider whether subsection 7(1.4) and subparagraph 110(1)(*d*)(iii) of the *Act* were applicable. They provided submissions agreeing that subsection 7(1.4) of the *Act* was not in play as there had been no disposition of rights under the original Stock Option Agreement. I will therefore not pursue this avenue of analysis further.

[20] The Respondent emphasized the time to determine whether the amount payable under the agreement is the time of the agreement. Clearly, the original agreement stipulated an exercise price of $10 per share, and at that time the shares were valued at $10 per share. The condition of clause 110(1)(*d*)(ii)A of the *Act* is therefore met argues the Appellant. But equally clearly, the agreement was at some point altered to reflect an exercise price of $2.02 per share. That was the price ultimately paid by Mr. Fettes. The evidence indicates that amount was less than the fair market value at the time of the original agreement and also less than the fair market value at the time of the exercise of the options at $2.02. I also find that the $2.02 was less than the fair market value at the time there was an agreement that the exercise price would be $2.02.

[21] The original written Stock Option Agreement defines the option price as $10 and goes on in section 4 to define the exercise price as the aggregate option price. That was not however the actual price paid, so how can it be said that it is the original agreement under which Mr. Fettes acquired the shares? The Appellant argues that section 4 describes the process for exercising the options and provides flexibility for a change in price. I disagree with the Appellant that this somehow sets the $10 per share price in stone so that parties could simply change the price and still take advantage of paragraph 110(1)(*d*) of the *Act*, affording capital gains treatment. No, the agreement under which Mr. Fettes acquired the shares to which subsection 7(1) of the *Act* applies could only have been an agreement at an option price of $2.02. There is no written agreement to that effect, nor any detailed explanation of how or when the option price changed to $2.02, but clearly it did.

[22] A repricing of the agreement occurred, and it is the repriced option agreement that was exercised.

[23] It makes no sense to me from a policy perspective that an option agreement set at a price equal to fair market value can willy-nilly be altered to a price less than the fair market value and still claim it reflects a policy to provide an incentive to an employee: there is no future incentive - the employee is receiving an immediate benefit. To suggest treating it otherwise would open the floodgates to abusive tax planning with a written agreement stipulating one thing and reality

dictating another. I am not for an instant suggesting that is the case with Mr. Fettes. He presented as an honest, straightforward individual caught in the tangled web of complicated tax legislation.

[24] In summary, I interpret the term "agreement" in clause 110(1)(*d*)(ii) of the *Act* to refer to the agreement Mr. Fettes had to acquire shares at $2.02 per share, a price less than the fair market value of the shares at the time of the original agreement, at the time of the repricing and at the time of the exercise. In these circumstances, the benefit Mr. Fettes realized pursuant to subsection 7(1) of the *Act* is not the type of benefit contemplated by paragraph 110(1)(*d*) of the *Act* that effectively provides capital gains treatment to the recipient of the benefit. It was simply an employment benefit to be brought into income.

[25] The Appellant goes on to argue that if I find Mr. Fettes has an employment benefit then the amount has been incorrectly calculated by CRA. CRA relied on the amended T4 filed by Watergroup, which indicated additional income of $233,765 with an increase in tax deducted of $102,250. Yet, the withholding analysis by Culligan (see paragraph 8 of these Reasons) suggests the withholding of US $108,830. There was no evidence of what Culligan actually remitted to the CRA. While I agree with the Appellant that this raises some question as to the accuracy of the numbers relied upon by the Respondent, the Appellant has not been able to provide me with any accurate alternative. In these circumstances, I am not prepared to accept the Appellant has demolished the Minister's assumptions.

[26] The Appeal is dismissed with costs to the Respondent.

Signed at Ottawa, Canada, this 6th day of August 2015.

"Campbell J. Miller"

C. Miller J.

SCHEDULE A

Culligan Ltd. Stock Incentive Plan

Equity Summary - Example

As of May 29, 2007

Portfolio Value	***$52,290.54***
Initial Investment	***$11,000***
Returns to Date	***$36,155.00***

Shares
Culligan Ltd.

Date	Shares Purchased	Basis	Distribution Formula	Distribution	FMV per Share	Market Value
December 30, 2004	1,000	$10.00			$10.00	$10,000.00
June 30, 2006					$13.75	$13,750.00
August 14, 2006		$8.59	Shares * $1.41	$1,410.00	$12.34	$12,340.00
September 15, 2006		$7.47	Shares * $1.12	$1,120.00	$11.22	$11,220.00
December 31, 2006					$12.35	$12,350.00
May 29, 2007		$8.05	Shares * $16.72	$16,720.00	$8.05	$8,050.00
Total	1,000			$19,250.00		$8,050.00
					Total Share Value	**$8,050.00**

Taxable Income (5/07) = $17,300.00

Deferred Share Units ("DSUs")
Culligan Ltd.

Date	DSUs	Basis	Dividend Formula	FMV per DSU	Market Value
December 30, 2004	100	$0.00		$10.00	$1,000.00
June 30, 2006		$0.00		$13.75	$1,375.00
August 14, 2006	11	$0.00	DSUs * $1.41/FMV	$12.34	$1,375.00
September 15, 2006	11	$0.00	DSUs * $1.12/FMV	$11.22	$1,375.00
December 31, 2006		$0.00		$12.35	$1,513.48
May 29, 2007	255	$0.00	DSUs * $16.72/FMV	$8.05	$3,035.54
Total	377				$3,035.54
				Total DSU Value*	**$3,035.54**

*Subject to tax.

Options*
Culligan Ltd. Stock Incentive Plan

			Vested Options			Unvested Options		
Date	Option Grant	Strike Price	Number Vested	Cash Bonus Paid	Value	Number Unvested	Deferred Bonus (Unvested)	Potential Value
December 30, 2004	2,000	$10.00	1,000			1,000		
February 9, 2005	1,000	$10.00	500			500		
August 14, 2006		$8.59						
September 15, 2006		$7.47						
February 8, 2007	500	$12.35				500		
May 28, 2007		$2.02		$16,905.00			$20,100.00	
Total	3,500		1,500	$16,905.00	$9,045.00	2,000	$20,100.00	$12,060.00
						Total Option Value*		**$41,205.00**

Options vest over 4 years from the date of the grant.
Option Value = Number * (FMV - Strike)
Cash Bonus = Options Vested * ($16.72 - Prior Strike + New Strike)
Deferred Bonus = Options Unvested * ($16.72 - Prior Strike + New Strike)
*Subject to tax upon exercise. Confirm treatment with your tax advisor.

CITATION:	2015 TCC 198
COURT FILE NO.:	2012-1230(IT)G
STYLE OF CAUSE:	DONALD FETTES AND HER MAJESTY THE QUEEN
PLACE OF HEARING:	Saskatoon, Saskatchewan
DATE OF HEARING:	June 17, 2015
REASONS FOR JUDGMENT BY:	The Honourable Justice Campbell J. Miller
DATE OF JUDGMENT:	August 6, 2015

APPEARANCES:

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Counsel for the Respondent:	John Krowina

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