Equity-Based Compensation for Canadian Employees

By

Leonard Glass

May 2, 2002

*This is a general overview of the subject matter and should not be relied upon as legal advice or opinion.
For specific legal advice on the information provided and related topics,
please contact the author or any member of the Tax Law Group.*

*Copyright © 2002, Lawson Lundell LLP
All Rights Reserved*

EQUITY-BASED COMPENSATION FOR CANADIAN EMPLOYEES

Introduction

A variety of equity-based compensation plans exist for employers wishing to provide an equity-based incentive to their Canadian employees. This paper will outline the basic terms of such plans and discuss their Canadian tax implications. Specifically, the following equity-based compensation plans are discussed in this paper:

1. Stock Options

2. Stock Purchase Plans

3. Deferred Bonus Plans

4. Restricted Stock Plans

5. Phantom Stock and Stock Appreciation Rights Plans

The tax implications discussed in this paper are contained in the *Income Tax Act* (the "Act") of Canada. All statutory references are to the Act, unless otherwise noted.

The basic rules which apply to equity-based compensation for employees are contained in sections 5, 6 and 7 of the Act. Sections 5 and 6 are general provisions which compel an employee to include in his/her income, salary, wages and other benefits received from employment. Section 7 is a provision which sets out the tax rules applicable to stock options.

It should be noted that under the definitions contained in subsection 248(1), a director of a corporation is considered to be an employee of a corporation in his/her role as a director. Thus, many of the concepts discussed in this paper apply equally to a director. Conversely, additional considerations arise where the employee is also a shareholder. The rules discussed in this paper, in certain circumstances, maybe displaced by the shareholder benefit rules contained in section 15.

Stock Options

The most often discussed form of equity-based compensation is a stock option. Under the terms of a stock option, an employee is given the right to acquire shares of the employer at a certain price. The right is exercisable on a specific date. The price that the employee will pay is referred to as the "strike price".

The stock option rules are contained in section 7. The basic requirement of section 7 is that an employer has agreed to sell or issue securities of the employer (or of a person who does not deal at arm's length with the employer). This requirement will be satisfied in more situations than just a standard stock option described above. The Canadian stock option rules have a much broader application than in other jurisdictions and specifically may apply to the gift of shares and share purchase plans, discussed below.

The Basic System

The introduction of the new deferral rules for stock options granted by public corporations brought change into an area that had seen little fundamental change in many years. The basic rules in section 7 are as follows:

1. The granting of a stock option to an employee is not a taxable event.

2. An employee is deemed to receive an employment benefit in an amount equal to the value of the stock minus the amount paid for the stock on the date that the stock option is exercised. The employee's cost in the stock is the market value of the stock on the date of exercise.

3. A sale of the stock by the employee gives rise to a capital gain or a capital loss depending on whether the stock increases or decreases in value after the date of exercise.

The employment benefit described in 2. is reduced by one-half (formerly three quarters when the capital gain inclusion rate in Canada was three quarters) if the following three conditions are satisfied:

1. The stock received by the employee is a common share. (The Act contains detailed rules to describe what constitute a common share for this purpose.)

2. The strike price is equal to or greater than the market value of the stock at the time the option is granted.

3. The employee deals at arm's length with the employer and with the issuer of the share immediately after the stock option is granted.

Under these basic rules, the Act provides an incentive for employers to grant stock options because the rules permit a deferral of the benefit associated with the stock option until the date of exercise. However, under these basic rules, an employee had little incentive to retain the shares acquired as a result of exercising a stock option because the exercise of the stock option triggered an employment benefit and thus a tax liability. These basic rules provided an incentive to an employee to sell the shares shortly after the date of exercise so that the employee would have cash to satisfy the tax liability associated with the employment benefit.

Another problem associated with the basic rules is that a subsequent decline in the value of the stock results in a capital loss upon disposition. A capital loss cannot be used to offset employment income. Thus, an employee would be taxed on the value of the stock option at the time of exercise and not necessarily receive tax recognition for the subsequent decline in the value of the stock. This problem was particularly acute where an employee exercised an option because the term of the option was expiring leaving the employee with the feeling that he/she had little choice but to exercise the option and trigger the employment benefit.

CCPC Rules

The Act contains further beneficial rules where an issuer qualifies as a Canadian-controlled private corporation ("CCPC"). Where the issuer of the stock is a CCPC the employment benefit is further

deferred until the time that the employee disposes of the stock. The policy's rational for this further deferral is recognition that the market amount for shares of a CCPC is often illiquid. The employee maybe left without the ability to dispose of the shares until the controlling shareholders sell their shares.

In addition to the deferral, the employment benefit may also be reduced by 50% if the employee exercises the option and retains ownership of the stock for a period of at least two years. Thus an employee of a CCPC has two ways in which the employment benefit may be reduced by 50% either under this rule or under the rule which applies to all stock options relating to the strike price.

A CCPC, as its name implies, is a corporation incorporated in Canada that is not controlled by non-residents and not controlled by public corporations. It is, as result of the definition of a CCPC, possible to have US investors in a CCPC so long as their stock ownership does not exceed 50% and the remaining 50% is owned by Canadian residents who are not public corporations (or controlled by public corporations).

Under recently enacted changes to section 7, employees of corporations that are not CCPC's may be able defer recognition of the employment benefit until the date the stock is sold if a series of requirements are satisfied. The new deferral rules apply to a "qualifying acquisition". These rules only apply where the employee elects to have the rules apply. A qualified acquisition will arise where:

- The acquisition of stock occurs after February 27, 2000.
- The three requirements for a reduction of the employment benefit in the non-CCPC situation would otherwise be satisfied.
- When the stock option is granted, the employee owns less than 10% of issued shares of any class of the issuing corporation, the grantor of the stock option, or the entity whose shares are the subject of the stock option.
- The stock must be listed on a prescribed stock exchange. Under Regulation 3200 to the Act, most US, European and Pacific Rim exchanges are considered to be prescribed stock exchanges.
- The employee must file the election to defer the employment benefit before January 16 of the year following the year in which the acquisition of the stock occurs. The election must be filed with the employee or the corporation issuing the shares and is not filed with the CCRA.
- The employee must be resident in Canada at the time that this stock is acquired.
- The "specified value" of the securities must not exceed $100,000. If the specified value exceeds $100,000, then the employee may elect to defer the recognition of the employment benefit in respect of up to $100,000 and the excess will constitute an employment benefit at the time the option is exercised.

The $100,000 limitation of the new deferral rules resembles the same limitation applied under certain US rules. It should be noted that the limitation is not computed based on the employment benefit (i.e. the value of the stock minus the amount paid), but purely based on the value of the stock that an employee may acquire at the time that the option is granted. The rules require that in each year in which an option has vested, a calculation must be made of the value of the stock at the time the option was granted. If that calculation results in an amount equal to or less than $100,000 then the number shares that vested in that year will be eligible for the deferral. Where the calculation results in an amount greater than $100,000, the employee must divide the amount in excess of $100,000 by the value of each share at the time of the stock option grant to determine the number of shares that do not qualify for the new deferral. Since the new deferral rules are based on the value of the stock at the time the option is granted, but not at the time the option vests or is exercised, there is no limit to the amount that may be deferred. An example of the application of the new deferral rules is attached to this paper as Schedule 1.

There are also rules which determine the order in which stock acquired under these rules is disposed of and the calculation of the adjusted cost base of stock (i.e. tax cost) acquired under these rules where the acquisition of stock occurs at different points in time. A detailed discussion of these rules is beyond the scope this paper.

There is an interesting interaction between the stock option rules and Canada's departure tax rules. Under subsection 128.1(4), a taxpayer is deemed to have disposed of all of his/her property for its fair market value immediately before emigrating (i.e. becoming a non-resident) from Canada. Absent rules to the contrary, a disposition of stock would give rise to a capital gain or loss upon emigration. There are two exceptions to the departure tax. The departure tax rules specifically excludes from the deemed disposition "the right of an individual under an agreement referred to in subsection 7(1) or (1.1)". The former reference is to the general stock option rules and the latter reference is to the CCPC rules. Thus there is no disposition of a stock option right at the time of emigration of an individual from Canada. This exemption is consistent with the fact that Canada taxes the individual in respect of the stock option after they have emigrated. A second exception exists within the stock option rules. It provides that for the purpose of the rule providing for a reduction in the employment benefit for CCPC options, no disposition occurs as a result of an emigration. Thus, the individual may still qualifies for the employment benefit reduction if the individual owns shares for more than two years even if in the middle of the two-year period the individual emigrates from Canada. Except for these exceptions, Canada's departure tax rules will apply to stock received upon the exercise of a stock option. Thus, the deferral of employment benefit provided by the new rules will cease upon emigration from Canada.

It should be noted that under the departure tax rules, the CCRA might accept security for payment of the departure tax. Thus, subject to the CCRA's discretion to accept various forms of security, the payment of the departure tax on stock option shares may be deferred.

Application to Employers

Under the Canadian stock option rules, employers cannot claim a deduction for the benefit that they have provide when an employee exercises a stock option. One of the more popular methods of lessening the impact of this rule is to provide an employee with the opportunity to sell "in the money" options back to the employer. It may be possible to restructure the repurchase so that the

employee still receives the reduced employment benefit inclusion while the employer receives a deduction for amounts paid to the employee for the surrender of the stock option.

Stock Purchase Plan

Under a stock purchase plan, an employee is allowed to set aside after-tax funds which will subsequently be applied to the purchase of stock. Typically, although not always, the employer matches the employee's contributions so that in effect the employees are purchasing stock at a discount. Under the terms of the stock purchase plan, purchases of stock occur at regular intervals.

The income tax implications of a stock purchase plan to an employee are relatively straightforward. The stock option rules contained in the Act do not apply because of the rules of the stock purchase plans. Thus, an employee recognizes an employment benefit in the amount of the employer's contribution at the time that the shares are purchased and registered in the employee's name. In addition, an employee will not be able to reduce the employment benefit because the shares are acquired by the employee at a discount from fair market value.

Deferred Bonus Plan

Under a deferred bonus plan, a bonus that would otherwise be received by an employee is contributed to a trust. That trust acquires shares of the employer or a related corporation on the open market. Within three calendar years following the year in which the services were rendered, the shares are distributed to the employee.

A deferred bonus plan is structured so that it avoids the "salary deferral arrangement" rules contained in the Act. If these rules apply, then an employee has an immediate income inclusion to the extent of the bonus at the time it would otherwise be paid. As well, the stock option rules are typically avoided so as to ensure a deduction for the employer.

Under Canadian income tax rules, a trust is a taxable entity. However, a trust receives a deduction from income for amounts that are distributed to its beneficiaries. Most deferred bonus plans provide that while the shares are owned by the trust, all dividends and other income earned by the trust are distributed to the employer leaving the trust with no income. The employer may then use these funds as a source of future contributions or for any other purpose.

Under Canadian income tax rules, a trust is deemed to have disposed of its assets at cost when distributed to a beneficiary in satisfaction of all or part of the beneficiary's capital interest. This rule applies to the distributions by the trust of the stock acquired with the bonus funds. At the time that the employee receives the shares, the employee includes in his/her income the fair market value of the stock as employment income. In effect, the taxation of the bonus has been deferred until the employee receives the stock. While the employer is able to claim a deduction for the deferred bonus plan that deduction is also deferred until the employee has an income inclusion. The amount that the employer may claim as a deduction is the lesser of its original contribution and the amount allocated by the trustee to the employee. A trust's allocation to its beneficiaries cannot exceed the amount included in the employee's income for the year, less any income earned in the trust and any contributions returned to the employees. As a result, where the stock has declined in value while it is held by the trust, an employer will not receive a deduction for the full amount contributed in the form of a bonus to the trust. The difference between the amount contributed and the amount

deducted maybe deducted in the future if the trust is in a position to allocate an additional amount to an employee.

Deferred bonus plans are flexible vehicles for providing equity-based compensation. They are more flexible than stock option plans because the trust is able to invest in a diversified portfolio so long as that does not defeat the employer's purpose for the plan.

Restricted Stock Plans

Under a restricted stock plan, an employee receives stock where the transfer of the stock by the employee is restricted. Because of the general terms of a restricted stock plan, the employee is unlikely to gain the deferral benefits of the stock option rules nor is the employee likely be able to reduce the employment benefit because the strike price is likely less than the market value of the shares at the time the employee receives the restricted stock option.

In contrast with US law, under the Canadian rules, an employee is generally considered to have acquired stock at the time when the general rights associated with owning stock have been received by the individual. Specifically, the individual is likely under Canadian law to have acquired the stock at the time when the employee can vote the shares and receive dividends on the shares. These two rights are sufficient indicators of ownership even though the individual is not in a position to sell the shares. In contrast, the US has explicit legislation in this regard that defers the stock acquisition date. Planning opportunities arise in respect of restricted stock option plans because of the different tax treatments in the two jurisdictions. For example, an employee who is about to be assigned to Canada may receive a right under a restricted stock plan. If the employee exercises that right prior to the assignment then under Canadian law the employee will have acquired the stock but may not have acquired the stock under US rules. A subsequent disposition of the stock after the restriction has been lifted will result in a capital gain for Canadian purposes effectively converting prepaid Canadian employment income into a capital gain.

Phantom Stock and Stock Appreciation Rights Plans

Phantom stock and stock appreciation rights ("SAR") plans are also not the subject of explicit Canadian legislation. If the rules of a plan provide that a sale or issue of stock will arise then it is possible that the stock option rules will apply. However, under a typical phantom stock or SAR plan, no share sale or issue occurs. Indeed, the very purpose of these plans is often to avoid issuing or selling stock to employees. The fact that the amounts received by the employee is dependant on the value of the stock of the corporation does not mean that the stock option rules apply. As a result, an employee will be required to include in income an amount received in the year of the receipt.

Since the stock option rules do not apply, then the restriction on the application of other provisions in the Act also does not apply. Thus, the various anti-avoidance regimes in the Act may apply. These regimes include rules for salary deferral arrangements ("SDAs"), retirement compensation arrangements ("RCAs"), or the employment benefit plans ("EBPs"). A detailed discussion of these rules is beyond the scope of this paper. However, it is possible to structure a phantom stock or SAR plan so that none of these regimes apply.

It should be noted, however, that there is an exception to the SDA rules for plans that are established primarily for the benefit of non-residents rendering services outside of Canada. Participants of these types of plans who are transferred to Canada are not subject to the SDA rule that requires an immediate income inclusion for the first thirty-six months of their employment in Canada. It may also be possible to argue that incidental participation by Canadian residents in a foreign plan does not fall within the scope of the SDA rules.

While there is no statutory rules governing SARs nor is there any case law, the CCRA has provided a significant number of interpretations on the application of the rules in the Act to SARs. The CCRA's position is that a SAR will not be viewed as a SDA provided the units have no initial value at the time of grant and the employee's entitlement is not deferred once the units become redeemable. This result may be contrasted with the result of a phantom stock plan. Typically, a phantom stock plan provides the employee with the right to receive the full value of the share at a future point in time. The CCRA considers an employment benefit to arise at the time the phantom stock unit is granted to the employee. The CCRA's position is based in part on the belief that the phantom stock plan is designed to compensate an employee for past services. In a typical SAR, the employee receives only the increase in value from the grant date. The employee is compensated only for future services.

SCHEDULE

YEAR 1

- Option granted to acquire 1,000,000 shares at $2.00 each
- Market value of shares at time of grant is $2.00 each
- Options vest at the rate of 100,000 shares per year starting in year 2

YEAR 4

- Employee exercises option to acquire 300,000 shares
- At that time, market value of each share is $3.00

ANALYSIS

- Employment benefit in year 4 is:

  ($3.00 - $2.00) x 300,000 x 50% = $150,000

- Since the value of the shares at the time of the grant was greater than $100,000 then not all of the employment benefit may be deferred
- The value of the shares at the time of the grant was $200,000 so the employee may defer

  $\frac{100,000}{200,000}$ x $150,000 = $75,000

  of the employment benefit until the year in which the employee sells the shares

- The employee must include $75,000 in income for year 4

Vancouver
1600 Cathedral Place
925 West Georgia Street
Vancouver, British Columbia
Canada V6C 3L2
Telephone 604.685.3456
Facsimile 604.669.1620

Calgary
3700, 205-5th Avenue SW
Bow Valley Square 2
Calgary, Alberta
Canada T2P 2V7
Telephone 403.269.6900
Facsimile 403.269.9494

Yellowknife
P.O. Box 818
200, 4915 – 48 Street
YK Centre East
Yellowknife, Northwest Territories
Canada X1A 2N6
Telephone 867.669.5500
Toll Free 1.888.465.7608
Facsimile 867.920.2206

genmail@lawsonlundell.com
www.lawsonlundell.com