# Practical Tax Considerations for Equity Compensation Plans

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# Agenda

- Equity Compensation Plan Overview
- Selected Practical Considerations
  1. General Structural and Timing Issues
  2. Withholding Requirements / Mechanics
  3. Section 110(1)(d) deduction
  4. US Persons and Dual Citizens
  5. Residency/Cross Border Issues
  6. Employee v. Independent Contractor characterization
  7. Valuation matters
  8. Foreign administered plans

# Equity Compensation Plan Overview

- Stock Option Plans
- Stock Purchase Plans
- Deferred Stock Units (DSU)
- Restricted / Performance Stock Units (RSU / PSU)
- Stock Appreciation Rights / Phantom Share Plans

# Types of Equity Compensation Plans – Stock Option Plans

- Employer agrees to sell or issue shares of its capital stock (or the stock of a non-arm's length corporation) to employee at a fixed price, i.e., the exercise price
- No tax consequences generally associated with option grant
- Income tax in respect of option benefit generally payable by employee when stock option is <u>exercised</u>, unless employee is eligible to defer (e.g., CCPC shares, subject to s. 7(1.1))
- Option benefit taxed under s. 7 with possible s. 110(1)(d)/(d.1) deduction
- Increase in share value post-exercise generally taxed on capital gains basis
- No deduction available to employer or any other person in respect of any actual or accounting expense associated with a section 7 benefit

# Types of Equity Compensations Plans – Stock Purchase Plans

- Often made available as part of an ongoing program to encourage employee savings and incentive alignment with shareholders
- Employees are able to set aside after-tax funds to purchase stock (say on a quarterly basis)
- Employer may offer discounted purchase price or other favourable arrangements (e.g., matching shares, interest-free loan)
- Employee may recognize an employment benefit at the time the shares are purchased (depending on quantum of share price discount)
- Benefit (if any) is generally subject to taxation under s. 7, with no available s. 110(1)(d) deduction (potential deduction under s. 110(1)(d.1)).

# Types of Equity Compensations Plans – Deferred Stock Units (DSU)

- Employee (including directors) has a contingent right to receive shares of employer (or equivalent value amount)
- May be settled in cash, shares bought on the open market or issuance of shares
- Typically have prescribed vesting conditions
- Deductibility to employer depends on means of settlement (cash/purchase of shares vs. issuance of shares as income)
- Generally taxed in employees hands under s. 5(1) of the *Act* (unless governed by s.7)
- SDA rules do not apply if Reg. 6801(d) conditions are satisfied (e.g., no entitlement to payment until employment terminated)

# Types of Equity Compensations Plans – Restricted/Performance Stock Units (RSU/PSU)

- A form of phantom share entitlement typically determined with reference to a formula
- Vesting conditions generally based on time, performance or a combination thereof
- Used to compensate employees in a way that aligns their interests with those of stockholders
- Advisable (when not settled with issued shares) to have vesting within three years to avoid classification as “salary deferral arrangement” (“**SDA**”)
- Tax on receipt (assuming no SDA rules) and deductible to employer at that time

# Types of Equity Compensations Plans – Stock Appreciation Rights (SARs) / Phantom Share Plans (PSPs)

- Employer contractually obligated to pay an amount equal to share value (in case of phantom shares) or the increase (if any) in share value (in case of SARs) from grant date through vesting date
- Deduction to employer generally available in year of settlement, assuming SAR/PSP is cash settled (or with shares bought in open market)
- SDA rules generally do not apply provided properly structured

# Practical Tax Considerations for Equity Compensation Plans

# 1. General Structural and Timing Issues

- Critical tax considerations include:
  1) Timing of income recognition (e.g., post-employment)
  2) Income characterization/applicable tax rate
  3) Deductibility profile
  4) Valuation/administration matters
  5) Cash-out rights
  6) Participant profile (e.g., residents, non-residents, combination
- Care must also be taken to ensure proper compliance with securities laws (e.g., does prospectus exemption apply?) any other regulatory requirements (e.g., privacy law requirements)

# 1. General Structural and Timing Issues

- Common exemptions to the application of the "salary deferral arrangement" rules (the "**SDA Rules**") in the ITA often impose meaningful temporal restrictions
  - Reg. 6801(d) requires no settlement of DSU plans prior to employment termination and not later than end of calendar year after year of termination
  - Para (k) of the SDA definition (often used for RSU/PSV plans) requires payment within 3 years after end of year in which "right" is granted
- Safe harbours?
- Tax compliance deadlines and reporting requirements
- Compliance with securities obligations (e.g., blackout period)

# 1. General Structural and Timing Issues

- Need to provide sufficient flexibility in plan to ensure:
  - Operationally, the employer can make the required payments within the prescribed time
    - i.e., don’t provide for payment on LAST day of payout period (e.g., typically don’t want payment requests for calendar year to be made much later than December 15th)
  - There are no regulatory impediments (e.g., blackout periods, etc.) which may prevent payment within prescribed time

# 1. General Structural and Timing Issues

- Also, where equity compensation arrangements are elective, consider timing of elections
  - Example:  Many corporations allow directors to choose to receive their compensation in some combination of cash, DSUs and stock options
  - Need to take care to ensure that election is permitted and that no constructive receipt arises
  - Funding requirements need to be managed

# 2. Withholding on Stock Settled Plans

- Before 2011
  - Withholding in respect of issuance of shares under stock-option (or other stock settled) plans either not required or relatively flexible (e.g., undue hardship exception)

- Post 2010
  - Employers are generally required to withhold in respect of all s. 7 benefits
  - No discretion on part of CRA to permit reduced withholding due to non-cash nature of compensation

# 2. Withholding on Stock Settled Plans

- Key statutory provisions
  - S.153(1) – general source deduction requirement for "remuneration"
  - S. 153(1.01) – treats any s. 7 benefit as a "bonus" for purposes of s. 153(1) payment
  - S. 153(1.31) – withholding in respect of s. 7 benefits cannot, generally speaking, be reduced under the "undue hardship" provisions of s. 153(1.1)
  - Important carve-out for CCPC shares

# 2. Withholding Requirements

**How to deal with withholding obligations?**

- Cash-out of stock entitlement in return for cash payment net of applicable withholding tax
- Employer pays the withholding tax and recoups from employee
  - repayment by employee
  - reduction in number of shares issued by employer
- Withhold from employee's other cash remuneration (if possible)
- Employee funds tax remittance
  - through partial sale of shares
  - other sources

# 2. Withholding Requirements

- Importance of building withholding mechanics into relevant contractual provisions in the relevant plan or award agreement
- Where s. 110(1)(d) deduction is being sought, need to be careful that withholding arrangement do not inadvertently taint shares status as “prescribed shares” (Reg. 6204)

# 3. Subsection 110(1)(d) deduction

- Where employee acquires shares on the exercise of an option to which s. 7 applies, employee may claim a deduction equal to 50% the stock option benefit, provided:
  - the shares are “prescribed shares” (Reg. 6204)
    - Shares with redemption or retraction features may not qualify.
  - the sum of the option exercise price and the amount paid (if any) to acquire the option was not less than FMV of the security at the time the option was granted; and
  - the employee deals at arm’s length with employer/ grantor at time of grant

# 3. Subsection 110(1)(d) deduction

- *Transalta Corp.* – s. 7 requires that there exist a legally binding agreement to issue the subject shares; and where an employer has the discretion under a compensation plan to issue shares or cash in satisfaction of the award, there is no agreement and a deduction may be available (due to the non-application of s. 7(3)(b))

# 3. Section 110(1)(d) – Election

- The s. 110(1)(d) deduction is not available (unless the employee <u>exercises</u> the option (by virtue of subparagraph 110(1)(d)(i))
  - Would not be available, as of right, in respect of cash-settled stock-option or cash-out of stock settled option
- Issue potentially addressed by s. 110(1.1)
- Permits employee to claim s. 110(1)(d) deduction, notwithstanding that she did not acquire shares, provided that the employer files a prescribed election in respect of all of the options granted to the employee under the stock option agreement.
- Election provides that neither the employer nor any person not dealing at arm's length with the employer will claim a deduction in respect of the option benefit realized by employee.

# 3. Section 110(1)(d) – Making the Election

- Employer makes election contemplated in s. 110(1.1) by entering the relevant option benefit amount under code 86, “Security options election,” in the “Other information” area of the employee’s T4 slip
- This allows the employee to claim the 110(1)(d) deduction (assuming all of the other relevant conditions are satisfied; if not, then no particular utility in making the election)

# 3. Section 110(1)(d) – Issues

- Availability of this deduction is fundamental in many cases to stock option compensation planning. Situations requiring particular consideration include:
  - “Reload options” – fair market value and availability of the one-half deduction
  - Option amendments, s. 7(1.4) and the addition of s. 110(1.7)-(1.9) (e.g., rights offering)
  - Cash-out of stock options in MiA context (capital account v. income account)

# 3. Section 110(1)(d) – Cash-out of stock options

- ***Kaiser Petroleum*** - cancellation payments to employees are non-deductible capital outlays when made in the context of an acquisition of all the shares of target.
- ***Shoppers Drugs Mart*** – payments made by Shoppers to its ParentCo for a one-time cash out payment to Shoppers' employees in the course of a Parent Co going private transaction was held to be on account of income, not capital.
- ***Imperial Tobacco*** – payments by corporation made to employees who disposed of their options in connection with a going private transaction are not deductible
- Relevant analytical and practical considerations

# 4. US Persons / Dual Citizens – Issues

- In designing equity-based compensation plans, care must be taken where recipients are “US Persons” potentially subject to US income tax
  - Approximately 1-2 million Canadians are US citizens and therefore “US Persons”
  - Not uncommon for directors, officers and key employees to be “US Persons”
- “US person” means:
  - a citizen or resident of the US; a partnership or corporation created or organized in the U.S. or under the law of the U.S or of any State, or the District of Columbia; any estate or trust other than a foreign estate or foreign trust; or any person that is not a foreign person.

# 4. US Persons / Dual Citizens – Issues

- Concern arises from possible mismatch between Canadian and US tax rules relating to (among other things):
  - timing of recognition of income
  - character of income
- Equity compensation plans which allows for a deferral under the *Income Tax Act* may result in an immediate income inclusion to employee under US *Internal Revenue Code* (and vice versa; e.g., restricted stock)
- Can give rise to significant unexpected tax liabilities and penalties
- Different timing of income may impair ability to claim foreign tax credits

# 4. US Persons / Dual Citizens – Issues

- In practice, it is often possible – with careful drafting – to design plan documents which appropriately accommodate both Canadian and US tax rules
- US rules are typically more restrictive than Canadian rules; therefore, important to consider:
  - Definitions and concepts
  - Triggering/recognition events
  - Separate provisions governing US Persons
  - Mechanisms for identifying US Persons

# 5. Residency/Cross-Border Considerations

- Cross- border tax considerations arise in respect of employees who relocating while entitled to benefits under compensation plan.
- Consider the following examples:
  - A Canadian resident individual is granted a stock option when employed in Canada and then moves to the U.S. prior to the exercise of the option
  - A U.S. resident individual is granted options while employed in the U.S. but then immigrates to Canada prior to the exercise of the option.

# 5. Residency/Cross Border Considerations

- Avoiding double taxation
- Leaving Canada – deemed disposition (s. 128.1(4).)
- Allocation of stock option benefits.

# 5. Residency/Cross Border Considerations

- Allocation of stock option benefit between US and Canada governed by paragraph 6 of diplomatic notes to US/CDA Treaty 5$^{th}$ Protocol.
  - Basis for apportioning taxing rights between Canada and the U.S. where an employee is granted stock options while resident/employed in one country but resident/employed in the other country at the time of exercise.
- *Per diem* approach – in most cases the stock option benefit is to be apportioned based on each day between the date of an option grant and the date of option exercise

# 5. Residency/Cross Border Considerations – Stock Option Benefit Allocation

- *Per diem* allocation:
- The proportion attributable to a Contracting State =
  - Income x (Number of days between the grant and exercise (or disposal) of the option during which the employee's "principal place of employment" was situated in that Contracting State divided by total number of days between grant and exercise (or disposal) of the option that the employee was employed by the employer)
- If the competent authorities of both Contracting States agree that the terms of the option were such that the grant of the option is appropriately treated as transfer of ownership of the securities (e.g., because the options were significantly in-the-money or not subject to a substantial vesting period), then they may agree to an alternative means of allocation.

# 5. Residency/Cross Border Considerations – Relevant Treaty Rules for Cross Border Employment

- General Rule: Source country can impose tax on the remuneration derived from employment exercised in the source country
- Article XV(2)(b) *Canada-US Tax Convention* may provide relief
  - A US resident who performs employment services in Canada, is exempt from Canadian source taxation on such employment income, if:
  1. Employee was not present for more than 183 days in Canada during any 12 month period (no straddling between two taxation years);
  2. Employee's remuneration cannot be "paid by, or on behalf of" a Canadian resident or "borne by" a permanent establishment in Canada.

# 6. Employee vs Independent Contractor

- It’s not uncommon for equity based compensation plans to contemplate that both employees (including director and officers) and contractors can participate in such plans)
- Important be alert, however, that the special provisions of the Tax Act governing such plans with respect to employees (e.g., s.7, reg. 6801(d), the “salary deferral arrangement” rules) do not apply to contractors
- Participating in compensation plans can have unexpected – and potentially adverse – tax consequences for contractors.

# 6. Employee vs Independent Contractor

- For example, a grant of a stock option (or other award) will usually give rise to a potential immediate income inclusion under s.9 equal to the value of that option (award)
  - Valuation of such options and awards can be problematic (depending on nature of award, vesting conditions, etc.)
  - Value of option (award) potentially subject to GST/HST/QST where services are taxable
- For non-resident contractors, grants of options (awards) can give rise to immediate withholding obligation under reg. 105.

# 6. Employee vs Independent Contractor

- Further, CRA has suggested that, where option is granted in respect of future services, a contractor may be required, in computing their business income, to include the difference between the value of the underlying stock at the time of exercise and the exercise price
  - Implicitly, s.49(3) does not apply in this instance
  - CRA Document no. 2002-0151247 and no. 1999-0013915
- Correctness of this position is debatable
- Interestingly, for GST/HST purposes, CRA says that this "income" is not subject to GST/HST

# 6. Employee vs Independent Contractor

- Need to be alert to underlying legal distinction between employees and independent contractors
  - Degree of control
  - Ownership of tools/equipment
  - Chance of profit
  - Risk of loss
  - See, for example, 671133 Ontario Ltd. V. Sagaz Industries Canada Inc. (2001 SCC 59), Wolf v. Canada (2002 FCA 96), and Royal Winnipeg Ballet v. M.N.R. (2006 FCA 87).

# 7. Valuation matters

- Commonly encountered issues requiring valuation analysis.
- When to obtain?
- Rules of Thumb.

# 8. Foreign Administered Plans

- Potential Canadian tax compliance gap (e.g., production of Canadian prescribed forms (T5, T5008 etc.)).
- Withholding tax and foreign treaty access.
- Entity classification issues
- Foreign filing requirements?
- Need for Canadian employee disclosure?

# Questions?

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