Stock-Based Compensation

Don’t Shoot the Messenger!

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Stock-Based Compensation

Agenda

- Why do companies want employees to be shareholders and why do employees want to be shareholders? Is there any common ground?
- Canadian income tax rules
- Various types of stock-based compensation plans
- US income tax rules
- Considerations before putting a stock-based compensation plan in place – the employee and the employer perspective
- Stock options or shares paid to independent contractors

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Disclaimer

Our lawyers make us say this…

This presentation is a general overview of what are sometimes very complex tax rules. Do not take this presentation and implement a stockbased compensation plan without first speaking to your lawyer, your HR consultant and a knowledge tax advisor.

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Why do companies typically want employees to be shareholders?

- Encourages employees to think like shareholders – thinking strategically, thinking long-term and thinking about the best interest of the company
- Stock or stock options offered as a performance bonus can incent a better performance and/or desired behaviors by key employees
- Retention of key employees
- A method of remuneration of key employees in which the company/employer does not have to come up with cash
- Having employees acquire shares is a method of raising capital for the company

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Why do employees want to be shareholders?

- Employees want to feel like they have an impact on the success of the company – they believe being a shareholder gives them influence over the strategic decisions of the
- Working as an employee for a living is not going to make one rich
- The employees read how other employees become rich from owning shares of their employer when the employer “goes public”

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Let's talk about the Canadian Income Tax Rules

If the Employer is a Canadian-controlled Private Corporation (CCPC)

If the company or an non-arm's length company agrees to issue shares out of treasury to an employee

- No taxable benefit when the option is granted
- The taxable benefit is calculated as the difference between the option price and the fair market value of the shares at the date the option is exercised, <u>but the benefit is not taxable until the shares are sold</u>
- In the year the benefit is taxed the individual will get a 50% deduction if the shares were held for at least two years

If the Employer is <u>not</u> a CCPC

If the company or an non-arm's length company agrees to issue shares out of treasury to an employee

- No taxable benefit when the option is granted
- The taxable benefit is triggered in the year the option is exercised and calculated as the difference between the option price and the fair market value of the shares at that date
- In the year the benefit is taxed the individual will get a 50% deduction if the option price was not less than the fair market value of the shares on the date the option was granted and the shares are "prescribed shares"
- ***Income tax withholdings due based on the taxable benefit due when the option is exercised!***

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Let's talk about the Canadian Income Tax Rules

If the Employee is provided with an option to acquire the shares on the open market…

The employee has a taxable benefit equal to the fair market value of the option on the date the option is granted – no 50% deduction

If the Employee is granted a right to receive an amount equal to the value of shares in the future…

The employee has a taxable benefit equal to the fair market value of the shares or "units" on the date the option is granted – no 50% deduction

If the employee is given a right to receive an amount equal to the increase in the value of the shares or "units" where the starting point is the current value and the benefit is the increase in the value there is no taxable benefit until value is received by the employee. Still no 50% deduction, but tax deferral.

No taxable benefit until cash or shares received even if there is an immediate value to the shares or "units", but the value cannot be received by the employee or former employee except on retirement, termination or death (received by the estate) and the value is paid no later than the end of the next calendar year.

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The Lexicon – Various types of stock-based compensation plans

- Employee Stock Option Plan (ESOP) – USA and CDN
- Employee Stock Purchase Plan
- Phantom Stock Plan – CDN
- Deferred Stock Plans (sometimes called "Retirement Stock Plans") – CDN
- Share Appreciation Rights Plan (SAR) – USA and CDN
- Performance Appreciation Rights Plan (PAR) – USA and rarely in Canada
- Restricted Stock Unit Plans (RSU) – USA and CDN
- Restricted Stock Awards (RSA) – USA
- Non-Qualified Stock Options (NQSO or NSO)
- Incentive Stock Options (ISO)

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Let's Talk About the US Tax Rules

If an employee is a Canadian resident, but a US citizen, the US tax rules will apply to him or her even if the employer is a Canadian company. If the timing of the tax in Canada is different than the timing of the tax in the US there may not be an ability to claim foreign tax credits and there could be double tax.

If an employee receives stock options while working and resident in the US and moves to Canada or vice versa, there could be an apportionment of the taxable benefit between Canada and the US based on number of days of service in the US and in Canada.

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Let's Talk About the US Tax Rules

Non-Qualified Stock Options ("NQSO" or "NSO"):

- No personal income tax on the grant of the option
- At the time of the exercise the employee has a taxable benefit equal to the difference between the option price and the fair market value of the shares at the time of exercise
- When the shares are sold the employee will have a capital gain equal to the difference between the selling price and the fair market value of the shares when the option was exercised. Whether the gain is taxed as a short term capital gain (taxed as ordinary income) or as a long term capital gain (effectively ½ taxable) will depend whether the shares were held for at least a year
- If the option price is less than the fair market value of the shares at the grant date the employee will have taxable benefit at grant date plus additional "penalty taxes"

Incentive Stock Options ("ISO"):

- No personal income tax on the grant of the option
- No personal income tax on the exercise of the stock option but may trigger AMT
- Taxable benefit triggered on sale
- If the shares are sold immediately after exercise, the difference between the option price and the fair market value of the shares on exercise is taxes as ordinary employment income
- If the shares are retained for at least a year after exercise and at least two years after grant date (fully vested) the difference between the exercise price and the selling price is taxed as a long-term capital gain

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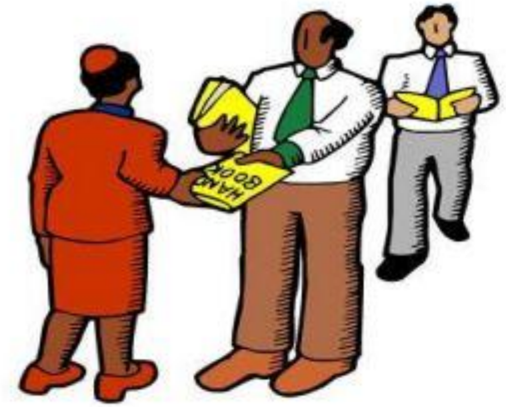
Before Putting a Stock-Based Compensation Plan in Place - Consider

Employee Perspective:

- Do employees really want to be shareholders?
- Will employees be happy holding the shares for many years or will they be wanting to cash out at certain milestone events (i.e., getting married, having kids, buying a house, kids going to school, etc
- Are employees comfortable with risk?
- Are employees needing to take funds out of their RRSP to acquire the shares?



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Before Putting a Stock-Based Compensation Plan in Place - Consider

Employer Perspective:

- Do owners want to show employees the corporate financial statements and income tax returns?
- Will owners be happy having restrictions imposed on their use of corporate assets - for example:
- No longer will the company be able to acquire a Porsche as company car for the owner
- No longer will Canucks season tickets be acquired by the company for the owner's personal use
- The company cannot acquire assets to be used principally by the owner
- Do the owners care if their compensation is scrutinized and limited to fair market value of the work done?
- Do employers/owners expect the employees to pay something for the shares so the employee has "skin in the game"?
- The dividend decision will become a finance decision because there are more shareholders than just the "owner"
- How will the company cash-out the employees' shares?

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Before Putting a Stock-Based Compensation Plan in Place

If the plan does not meet the needs of both the employer and employee, you have a very expensive and non-deductible bonus plan!

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