Employee Incentive Program

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Types on Employee Incentives

Bonus plan, RSU, DSU	Fully Taxable
Medical, dental, group plans	Not taxable but not high value
Club Membership	Possibly not taxable, but not deductible to employer
Housing loan, car loan	Could be made to employee (non-shareholder) but has to be repaid, imputed interest

There are various forms of employee incentive programs. Below are the common ones.

Bonus plan, RSU, DSU. These types of plans have become popular particularly in remunerating executives of public companies through plans called RSU's and DSU's. These plans provide a tax deferral, but ultimately result in employment income which is fully taxable.

Medical, Dental, group plans. These plans are deductible to the employer, and not generally taxable to the employee. However, they tend not to be regarded as being of high value.

Club membership. If the club membership is for the benefit of the employer, then it is not a taxable benefit to the employee. However, it is not deductible to the employer. These arrangements result in "perk" to the employee, but not a cash payment.

Housing loan, car loan. If the employee is not a shareholder, then these types of loans can be made either interest free or at a low interest rate. If made interest free, there is an imputed benefit at the prescribed rate. These may be regarded as valuable to the employee, but the loan has to be repaid.

Types on Employee Incentives

Company car	Taxable benefit, standby charge
General Perks, e.g. convention, business trips	Not taxable but limited value
Gifts	Not taxable within small limits
Prizes, awards	Taxable with possible $500 excluded

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Company car. A taxable benefit results for the usage of the car and also a standby charge. The standby charge can be expensive.

General perks, such as attendance at a convention, business trips etc. These are generally not taxable to the employee, and deductible to the employer provided they are primarily business related. However, they have limited value.

Gifts. These are not taxable within certain small limits (by administrative policy $250 generally, which can be paid twice a year).

Prizes, Awards. These are taxable to the employee, with the potential to exclude $500 if certain conditions are met (a prize or award in a field of endeavor).

Types on Employee Incentives

Courses	Not taxable but not high value
Stock options	50% taxable if conditions met, may be high value
Co-Ownership, shares etc.	50% taxable as capital gain, may be high value
Loan to buy shares	Imputed interest but may be deductible, has to be repaid
Loan and forgiveness	Employment income

Of these, stock options are most common tax effective high value choice

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Course. The payment of course fees is not a taxable benefit to the employee, provided the course is for the benefit of the employer. However, this does not result in cash to the employee and it is not perceived to be of high value.

Stock option plans. Can be of high value, and be very motivating. If certain conditions are met, then only 50% of the employment benefit is included in income.

Co-ownership, ownership of shares etc. These arrangements are designed to produce a capital gain, which Is 50% taxable. They may be of high value, but are normally structured in a customized way. They are not as easy to structure as stock options, and their use is more limited.

Loans to buy shares. An employer may make an interest free loan to an employee to buy shares in the company. The loan must be made by virtue of employment, and not by virtue of shareholding, or the entire amount of the loan will be included in income. Imputed interest may apply if the loan is interest free. The imputed interest is deductible as interest paid. Importantly though, the loan has to be repaid.

Loan and forgiveness. Sometimes loans are made to an employee which can be forgiven in certain circumstances. If the loan is forgiven, then the amount of the benefit from the forgiveness is included as employment income and therefore is fully taxable.

Of these various arrangements, the most common and tax effective is stock options. These are perceived to have a high value, and if structured so that only 50% of the stock option benefit is taxable, these are a very good alternative to regular compensation.

Stock Options

- Compensation strategy for employees for options in shares of corporations and units of mutual fund trusts ("MFTs")
- Employee have an option to purchase shares or units of the employer, or of an entity that does not deal at arm's length with the employer
- An employee may purchase a specified amount of shares or units at a particular price ("strike price"), and may only be entitled to the option over a period of time ("vesting period")

Stock options are a common strategy to provide an incentive for employees of corporations and also mutual fund trusts. The employee is given an option to purchase shares under certain conditions at a price commonly called the strike price. The options may be exercisable immediately, or over a period of time, called the vesting period.

Overview

- Uses of stock option
  - Shares issued to a key employee as an incentive or a bonus
  - Fundraising activities from employees
  - Employee/management buyout of a company
  - Employee retention (due to vesting)

In designing a stock option plan, it is important to be clear on what the purpose of the stock option plan is. It can serve a number of purposes.

Issuing stock options to certain key employees may act as an alternative to a bonus plan, and be viewed as additional compensation.

If the plan has a material amount for the strike price, then the purpose might be in part to raise funds from employees. Another purpose may be to prepare for or execute a management buyout of the company.

Stock option plans, particularly with vesting requirements, are commonly used for employee retention.

It should be noted that stock option plans can become demotivating if the share price goes down, rather than up, particularly if it is below the strike price.

Strike Price

Price at which shares can be purchased

Nominal strike price	• Allowed for employee • May result in option benefit fully taxable • No real funds contributed by employee to corporation
FMV strike price at time option granted	• Funding of payment by employee in disincentive to exercise and hold (could be loaned from corporation) • Allows 50% deduction if other conditions met (discussed later)
Floating strike price at FMV at time of exercise	• Usually not done • Becomes stock purchase program as no benefit at exercise

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The strike price can be an nominal amount, the fair market value at the time the option is granted, or the fair market value at the time the option is exercised.

Normally shares must be issued for fair market value, but there is an exception for an employee, allowing the corporation to issues shares below fair market value. This may result in the option benefit being fully taxable on exercise or in certain cases on sale of the shares. The benefit of a nominal strike price is that the employee does not have to contribute any significant amount of funds in order to exercise the option.

Having a strike price equal to the fair market value at the time the option is granted is the most common of the various alternatives. In order to exercise the option, the employee must fund the exercise price (although this could come from a loan from the corporation). This allows for claiming of the 50% deduction if various conditions are met which are discussed later. To obtain the 50% deduction, it does not matter if the shares have increased in value at the time the option is exercised; what is important is that the option is not “ in the money” at the time the option is granted.

It is also possible to have a floating strike price, based on, for example, the fair market value of the shares at the time of exercise. This is not common, and essentially the plan becomes a stock purchase plan with no benefit resulting at exercise because fair market value is paid.

Vesting

Conditions placed on exercise of stock option
Typically must be employed at time of exercise, otherwise forfeit
Immediate vesting - can exercise immediately
3 year vesting - 1/3 per year
5 year, 10 year vesting
Determining vesting conditions is central to stock options plan
Further refinements may be:
On death or disability may vest or partially vest
On sale, liquidity event, may immediately vest

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Various conditions can be placed on the exercise of the stock option. This is commonly referred to as vesting. It is typical for stock options to vest over a period of time, with the condition that the employee must be employed at the time of exercise and otherwise the stock options are cancelled.

Various arrangements can apply to vesting. For example, the options could immediately vest at the time of grant. Alternatively, the options may vest over a three year period at 1/3 per year, or a five year or even a ten year period.

Determining the vesting conditions is a main feature of the stock option plan. There can also be further refinements which may allow for accelerated vesting. Some stock option plans may provide for immediate vesting on death or disability, and in the event of a sale of the company. In practice, a large number of variations are possible with respect to vesting.

Shareholders Agreement

Agreement governs shares once exercised

Typical provisions:

Drag along/tag along

No minority discount

Forced sale on ceasing employment

- At exercise price if dismissed for cause, bankrupt
- At FMV on death or disability
- At book value or some formula if cease employment

Often employer given power of attorney to transact shares (prevents unwilling employee from refusing to act)

Typically for private corporations, the stock option plan will also include a shareholders agreement. This typically restricts the employee in a number of ways but also provides certain rights to the employee.

Typical provisions include a drag along/tag along right, and a valuation where no minority discount is taken. The drag along/tag along right requires the employee to sell in the event of a sale approved by a major shareholder or a majority of the shareholders, and also provides that the employee receives the same price as everyone else (the tag along right). Very often the shareholders agreement will provide for no minority discount on a sale, so that all employees receive the same price per share as the major owners.

The shareholders agreement may also provide for a forced sale on ceasing of employment. While there can be many variations, it would be typical to provide for a buyback or redemption of the shares at the exercise price if the employee is dismissed for cause or becomes bankrupt. There may be a buyback at fair market value in the event of death or disability. Another arrangement may be a buy back at book value or based on some formula if the employee ceases to be employed for other than cause.

Very often a power of attorney is given to the employer to transact in the shares in accordance with the agreement. This prevents an unwilling employee from simply taking no action and refusing to sign paperwork etc.

There are some legal questions as to how far a shareholders agreement can go with respect to buying back the shares at below fair market value. Minority shareholders have certain rights and these statutory rights may govern regardless of what the shareholders agreement says. This is a matter for legal counsel to determine.

Taxation of Stock Option

- Employment income inclusion for benefit
- 50% deduction available provided conditions met
- Net result is to approximate capital gains treatment
- Further relief if option on public company and shares donated
- Non-CCPC/MFT and CCPC have different conditions

In simple terms, the benefit from exercise of the stock option is taxed as employment income. The benefit is the difference between the strike price and fair market value at the time of exercise.

A 50% deduction from the employment benefit is avaible if certain conditions are met. These conditions fall into two categories, CCPC and non-CCPC, with the non-CCPC falling into two sub categories, one of which limits the amount of the deduction to $200,000 per vesting year.

The end result of obtaining the 50% deduction is to approximate capital gains treatment. However, note that the stock option results in an employment benefit and potentially a 50% deduction, rather than a capital gain as such. This becomes very relevant if the price declines in the future.

Stock options exercised to receive shares in public company which are donated produces the same result as a donation of appreciated stock. In some cases this can be very beneficial because no employment benefit actually results. Various conditions apply.

Taxation of Stock Option

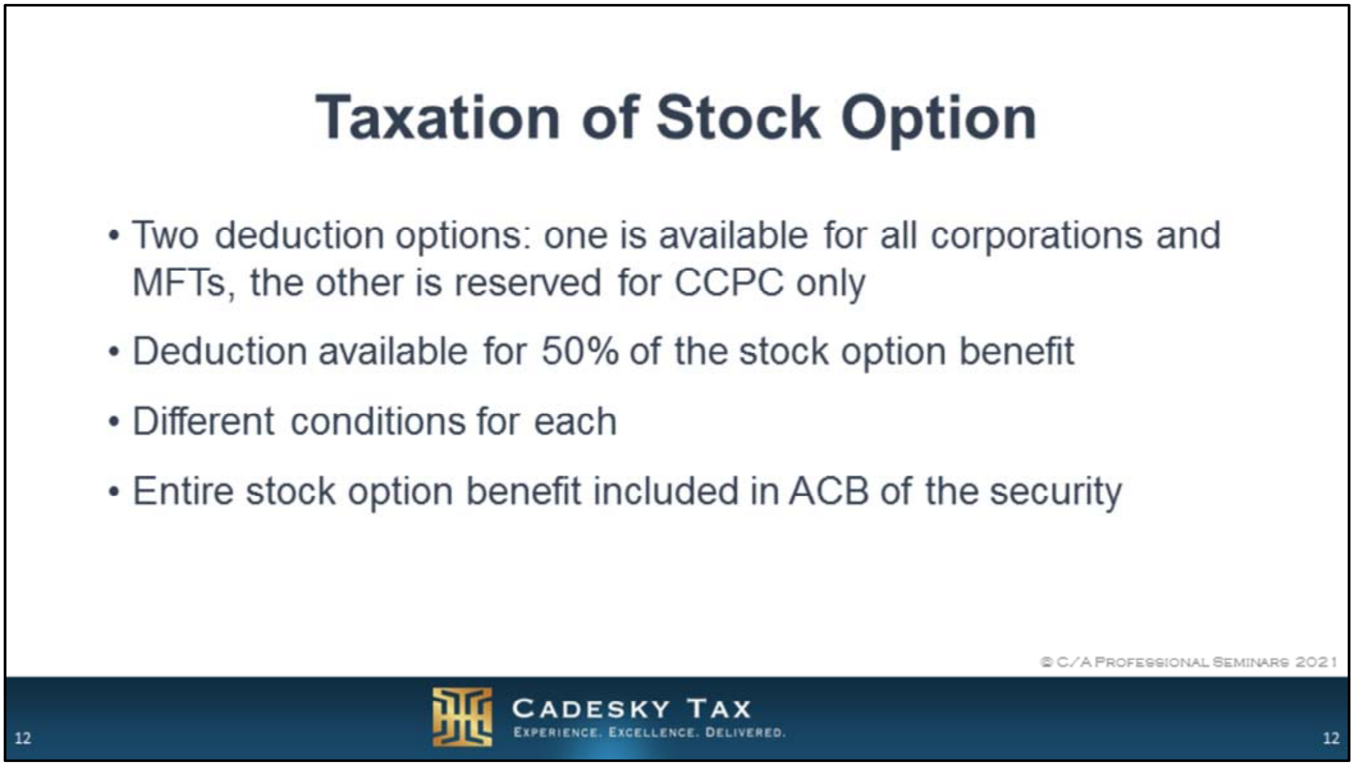
- Employment income inclusion
  - Value of the security minus:
    - Amount paid by the employee to acquire the security (strike price); and
    - Amount paid by the employee to acquire the option
- Timing of employment income inclusion varies
  - Non-CCPC / MFT: in the year of exercise
  - CCPC: in the year of disposition (except NAL employees)

The calculation of the benefit is under paragraph 7(1)(a) of the Act. This calculation does not change whether the employer is a non-CCPC or CCPC or mutual fund trust.

If a CCPC grants a stock option to a NAL employee, the timing of the stock option benefit will default to the year of exercise and not when the shares are sold. One will also discover later that being a NAL employee disqualifies the employee from the stock option deduction meaning compensating NAL employees with stock option does not offer significant tax advantages.

The employment benefit which is included in income is the value of the security at exercise less the strike price and any amount paid by the employee to acquire the option in the first place. Typically employees do not pay any amount to acquire the option, so this is not commonly seen.

The timing of the employment benefit varies. For a non-CCPC, the employment benefit occurs in the year that the stock option is exercised. For a CCPC, the benefit occurs in the year the shares are disposed of except for non-arm's length employees, where CCPC treatment is not available.



The two stock option deductions are pursuant to paragraphs 110(1)(d) for non-CCPC / MFT and 110(1)(d.1) for CCPC.

The amount of stock option benefit (before the 50% deduction) is added to the shares of the securities acquired as per paragraph 53(1)(j) of the Act. This ensures that upon sale of the security the option benefit is not taxed again as a capital gain to prevent double taxation.

The 50% stock option deduction has two sets of rules one for CCPC's and one for non-CCPC's. For non CCPC's, the question is whether at the time of grant, the strike price is at least equal to the fair market value of the shares. Then the deduction is available, subject to the $200,000 limitation discussed later. In addition, the shares must essentially be common shares.

For CCPC's, the 50% deduction is available if the conditions above are met or, alternatively, for any shares provided the shares are held for at least 24 months after exercise.

In both cases, the ACB of the security is the entire amount of the stock option benefit plus the price paid. Even though the 50% deduction may be available, the entire amount is still included in ACB.

Taxation of Stock Option

	General – 110(1)(d)	CCPC Only – 110(1)(d.1)
Share class	Prescribed shares (1)	Any security
Option benefit recognition	On exercise	On sale
In the money (2)	No	Can be
Arm's length	Yes	Yes (3)
Holding period	None	2 years

This slide shows a comparison of the stock option treatment in general, and the specific rule applicable to CCPC's.

1. In order to qualify for the deduction under paragraph 110(1)(d), the security to which the option relates must be a "prescribed share" as defined in Regulation 6204. In practice this by and large refers to plain vanilla common shares. This requirement does not appear to be present in the deduction under paragraph 110(1)(d.1).
2. This means the strike price cannot be lower than the FMV of the security in question at the time of the grant. This prohibits the deduction for employees immediately having a benefit when the option is granted by the employer. Again this condition seems to be only applicable to paragraph 110(1)(d).

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3. The paragraph 110(1)(d) deduction requires the employee to be dealing at arm's length with the employer immediately after the option is granted. Although the deduction under paragraph 110(1)(d.1) does not have the same requirement, the employee must also be eligible for the deferred option benefit recognition (from exercise to sale) to qualify for the 110(d)(1.1) deduction. In order to be eligible for the deferred income inclusion treatment the employee must be dealing at arm's length with the employer immediately after the grant. Therefore, in practice the employee has to be at arm's length in order to get either deduction.
4. If a 110(1)(d.1) deduction is not available, the employee may take a deduction under 110(1)(d) instead. However, no amount can be deducted under 110(1)(d.1) if an amount is deducted under 110(1)(d). Given the option deduction can only be taken in the year when the option benefit is included in income, care should be taken at the time of grant to determine which deduction would be applicable.

For MFTs, the general deduction under 110(1)(d) applies. However, if the agreement is for stock of a CCPC controlled by a MFT, then the 110(1)(d.1) deduction may be available as well.

Taxation of Stock Option

CCPC – Common Mistake

Canco, a CCPC, owned by Tom.

Canco sets up stock option plan. Tom's son Tim is an employee of Canco. Tim given stock option on same terms as other key employees.

Tim is NAL with Canco. Does not get CCPC treatment, has employment benefit on exercise.

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In this example, Tim is an employee and is the son of the major owner, Tom. The corporation, Canco, is a CCPC. Tim's stock option plan is similar or identical to other key employees. However, because Tim is non-arm's length with Canco (his father controls the company), he does not get the CCPC stock option treatment. He will have an employment benefit at the time he exercises his stock options, rather than at the time of sale. He does not get the 50% deduction.

The same result, employment income, can apply if a non-arm's length employee merely subscribes to shares at below FMV.

The subscription does not need to be part of a formal stock option plan; simply issuing shares may be sufficient.

Recent Changes

- Options granted after June 30, 2021
- Stock option deduction now has an annual limit of $200,000 (not indexed)
- Option benefit beyond the $200,000 annual limit fully taxed
- Does not apply to CCPCs and non-CCPC/MFT employers with consolidated group revenue of $500 million or less

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These changes received Royal Assent on June 29, 2021 and are now law. It only applies to stock option granted after June 30, 2021.

The $200,000 limit can be quite misleading because it does not mean an employee is given an annual maximum stock option deduction of $200,000 . In fact, the calculation determines the number of securities in a given year that are not eligible for the deduction and the option benefit pertaining to these "non-qualifying securities". The $200,000 limit is merely saying that the option benefit pertaining to $200,000 worth of shares vested in a particular year do not suffer from the limitation. Of course, shares granted prior to June 30, 2021 but vested after are not restricted to the $200,000 annual limit.

Stock option benefit beyond the $200,000 limit is not eligible for the 50% deduction or the additional deduction if the underlying securities are donated.

The entire stock option benefit is still added to the ACB of the shares so no double taxation upon disposition.

This limitation does not apply to CCPC's, or to non-CCPC's with consolidated group revenue of $500 million a year or less.

Strike Price

Valuation Issues

Stock option benefit rules use term value not fair market value.

Not sure if a real difference

Value may be "reduced" due to:

Minority discount (but need to consider terms of shareholder agreement)

Vesting conditions

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One question which often arises is the determination of fair market value in the context of the stock option benefit rules. Curiously section 7, which is the main provision which determines the benefit, uses the term "value" and not fair market value. Whether or not there is a real difference in meaning due to this choice of words is open to some interpretation. Sometimes people will take a discount in fair market value due to a minority shareholding, or due to vesting conditions. Whether or not this becomes relevant will depend on all of the surrounding circumstances. An exercise and sell strategy will render any discount argument irrelevant. An exercise, hold and later sell scenario will make this relevant, to decrease the employment benefit and increase the capital gain. It is common to take some amount of a discount particularly due to a minority interest and restrictions, if applicable, on the sale of the shares (escrow requirements).

Strike Price

Example

Ben exercises stock options, obtains 1% of CCPC. No Shareholder agreement. Shares not marketable. If FMV of CCPC shares in total is say $4 million, Ben's shares may be worth below $40,000.

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In this example, Ben obtains 1% of the shares of a CCPC. There is no shareholders agreement. The shares are not marketable. If the value of 100% of the shares was say $4 million, Ben's shares may not actually be worth $40,000 because of minority discount. How much of a discount might be taken will depend on a review of all of the circumstances, and this should be considered by a qualified business valuator.

Strike Price

Example

Carol granted stock option in Pubco at $6. Market price is $7. Options cannot be exercised for 3 years.

Possible that $6 may be her FMV

But 50% deduction provision says:

"Amount payable to acquire security not less than FMV at time agreement made"

So discount argument above is risky.

Since tax benefit of 50% deduction may be far larger than $1, usually risk not worth taking.

In this example, Carol is granted a stock option to buy shares of Pubco, a public company, at $6 a share. The market price at the time of grant $7 a share. The options cannot be exercised for three years. The question is whether she can obtain the 50% deduction.

The deduction provision states "the amount payable to acquire the security is not less than the fair market value at the time the agreement is made".

Based on this, it would seem to be a risky proposition to argue that $6 is actually the fair market value of the shares when the market price is in reality $7.

It may not be sensible to even entertain this type of strategy, because the benefit of the 50% deduction may actually be larger than the $1 which might be saved by Carol in using a strike price of $6 rather than $7. Of course this will depend on future events, such as the future fair market value at the time the option is exercised. This should be kept in mind.

Recent Changes

- Ann was granted options on June 1, 2020 for 10,000 shares of Canco at $6 per share, which equal to FMV at that time
- These options vest on July 18, 2021
- Ann was granted a further option on July 2, 2021 for 50,000 shares at $65 per share, which again equal to FMV at that time
- These new options vest immediately
- Ann exercised all options on September 30, 2021 when the share price was $90 per share
- Canco is large public company, revenue over $500 million

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The first batch of options were granted prior to July 1, 2021 and therefore, not impacted by the new rules. Therefore, Ann still includes stock option benefit of ($90 – $6) x 10,000 = $840,000 in her income as stock option benefit. Provided she meets the applicable criteria, her stock option deduction in respect of these options are $420,000.

For the second batch of options, employer has to calculate the number of securities that do not qualify for the option deduction, otherwise known as non-qualifying securities. The calculation is very complex. The calculation of the number of non-qualifying securities in respect of a particular option agreement is: A / B

A = C + D - $200,000

B = amount computed under C

C = total FMV of securities having the same vesting year under the same option agreement

D = lesser of $200,000 and total of C pertaining to other option agreements entered into prior to grant date of the particular agreement in question

In this case:

B and C are $65 x 50,000 = $3,250,000

D is lesser of $200,000 and $0 (the other agreement was prior to July 1, 2021)

A = $3,250,000 + 0 - $200,000 = $3,050,000

A/B = 93.85%

This means 93.85% of the 50,000 shares, or the stock option benefit relating to 46,923 of the 50,000 shares acquired are not eligible for the deduction. This means Ann has to include ($90 - $65) x 50,000 = $1,250,000 of option benefit in her income. Her stock option deduction, if available, will be limited to 3,077 shares, or 50% x $25 x 3,077 = $38,462.50. Under the old regime, Ann would be entitled to a deduction of 50% x $25 x 50,000 = $625,000. The difference in taxable income is $586,537.50 and assuming top marginal Ontario rate the additional tax is $313,973.52.

When stocks are vested under multiple agreements for a year, the non-qualifying securities computation for each agreement will be on a FIFO basis and element D keeps track of the cumulated "eligible room" that have been used up from these earlier agreements.

Fortunately, the employer will provide the calculations and the figures will be shown on a T-4.

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Options issued by different arm's length employers have a separate $200,000 annual limit. However, the limit has to be shared by non-arm's length employers.

Only the stock options vested in a particular year would be included in the $200,000 annual limit calculation. Therefore, the "vesting year" of a particular stock option needs to be determined. The vesting year according to the law is different depending on how the stock option agreement is worded. If the option agreement specifies the vesting time, then the vesting year is the calendar year. If the agreement is silent, then option is considered vested on a pro-rata basis over the period of time between the grant date and last date of exercise, subject to a 60 month limit.

Example – Decline In Value

Derek exercises stock option of Pubco shares, 100,000 shares granted in 2019.

Strike price $1 (was FMV at grant)

FMV at exercise $19

Pubco revenue under $500 million

	Per share	Total
Benefit	$18	1,800,000
50% deduction	(9)	(900,000)
Taxable amount	$9	$900,000
Tax (approx.)	$4.50	$450,000

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In this example, Derek exercises stock options to purchase $100,000 shares of Pubco, a public company. The strike price is $1 a share which is assumed to be the fair market value at grant. The fair market value at the time of exercise is $19.

Derek's stock option benefit is $18 per share and he may claim the 50% deduction. Thus the amount included in income is $9 per share or $900,000 in total. Assuming a 50% tax rate, he pays about $450,000 in tax.

Example – Decline in Value Continued

Derek invested $100,000 to fund

Tax paid $450,000

Suppose shares later become worthless.

Derek loses $100,000 contributed

Derek has capital loss $1,900,000

May not be able to use

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Now consider what happens if the shares become worthless. Derek has invested $100,000 to exercise the option, and paid tax of $450,000 on the stock option benefit. Derek has a capital loss of $1,900,000, but this capital loss may not be avaible for him to actually use. The capital loss cannot be applied against the employment benefit. This can represent a very significant financial hardship. In addition, the situation would be even worse if Derek was not able to claim the 50% deduction (because the strike price was in the money, or is restricted in claiming the deduction because of the new rules limiting it to $200,000).

When to Exercise/Sell

Important question

Note possible adverse tax result

Note financial cost to exercise

When to exercise the stock option, and whether to exercise and hold or exercise and sell are important questions. Note the adverse tax result on a decline in value, and also the financial cost to exercise the option. If the 50% deduction is not available, or is restricted, this makes the tax risk even bigger.

Example Continued

Assume price rise to $23
Derek may exercise now at $19, or in 1 year (assume then $23).

	Now	In 1 Year
FMV assumed	$19	$23
Cash needed	$1	$1
Benefit	$18	$22
50% deduction	(9)	($11)
Net income inclusion	$9	$11
ACB	$19	$23
Sale (in 1 year)	23	23
Capital Gain	$4	NIL
Taxable	$2	-

No tax difference to exercise and hold. Financial risk, but result worked out.

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Continuing with the example of Derek, suppose he has two choice, to exercise and hold the shares for one year, and sell at $23, or to exercise one year later at $23 and immediately sell.

If Derek exercises the stock options and holds the shares, and sells a year later for a $4 increase then he will have a $4 capital gain. On the other hand, if he waits a year, exercises when the shares are worth $23, and sells immediately, than all of the benefit will be employment income, and the 50% deduction will apply.

The end result is that in both cases the amount included in income is the same, so there is no particular difference in this example. However, if he exercises and holds, then he takes a greater financial and tax risk if the shares go down in value. For this reason, many people exercise and sell immediately, to minimize the risk.

Also if the 50% deduction is limited or not available, early exercise is better.

Cashless Exercise

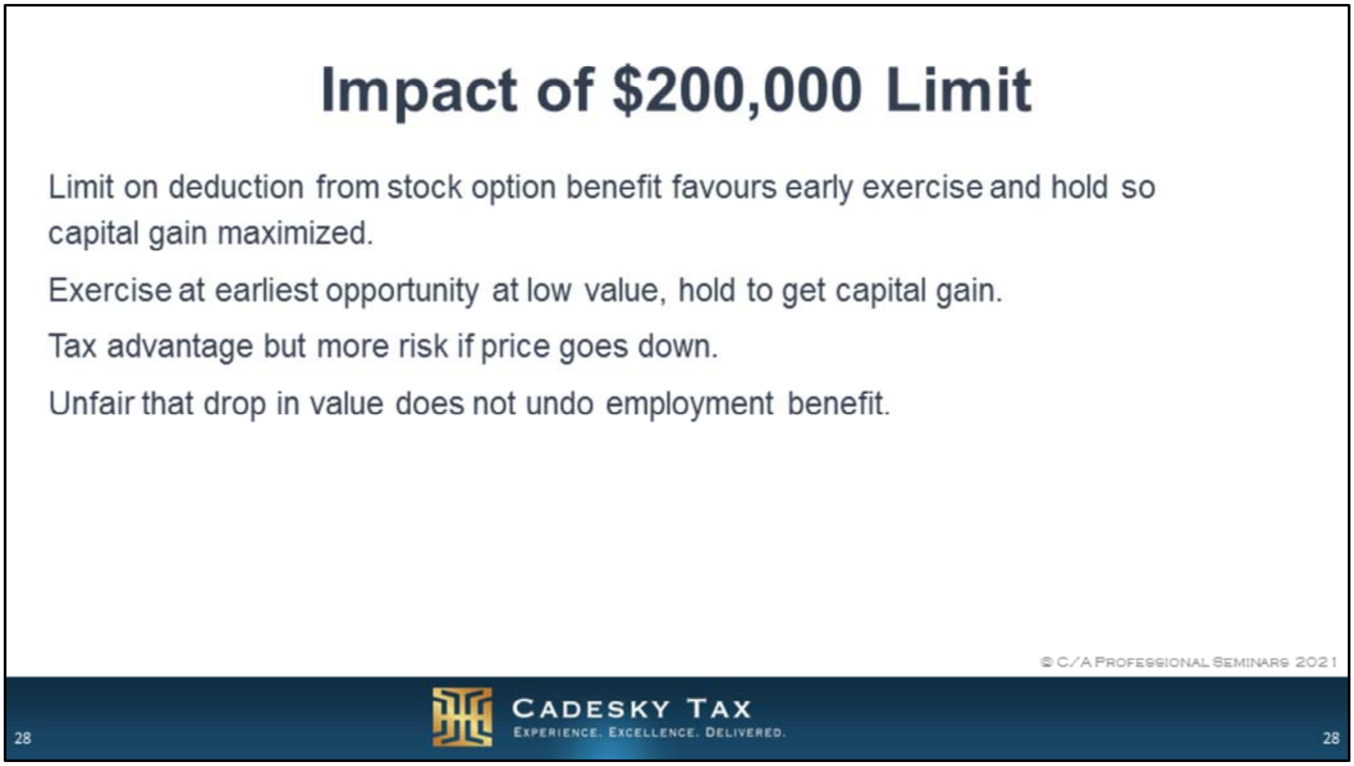
Sometimes corporation will allow cashless exercise.

Short term loan given, options exercised, shares sold, loan repaid from proceeds.

Note withholding tax to be paid from proceeds

It is possible to have a so called “cashless“ exercise . The option is exercised and the shares are sold in the marketplace, and the amount required to be paid to exercise the option is taken from the sale proceeds. In practice, someone is making a short term loan to fund the exercise price. This may be the broker who advances the funds against the security of the shares, or the company.

Note in addition, that source deductions are required to be taken by the company for the estimated tax that will be payable. This increases the amount of cash that is required. Returning to the example of Derek, if he choses to exercise and hold, he will have to find a way to fund the withholding tax. Possibly he will sell some portion of the shares sufficient to provide this amount of liquidity. The 50% deduction can be taken into account in determining the amount of withholding tax.



With the restriction now applicable on the 50% deduction, this favors exercising at the earliest possible time, at the lowest possible value, so as to maximize the capital gain component. However, this induces employees to take a greater risk than they otherwise would, and accept the exposure that the price could go down, in the hope of getting a better tax result. The fact that the drop in value does not reduce the employment benefit is inherently unfair.

CCPC Issues

May need to exercise and hold 24 months for 50% deduction

Exercise and hold strategy still risky if price drops.

But even more incentive if SBC, to meet 24 month holding period for capital gains exemption.

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With a CCPC, where the option benefit results only at the time of sale, this is still a risky strategy. If the price drops, will the company go bankrupt and the shares become worthless, the same tax asymmetry applies. This is exacerbated even more if the employee has to hold the shares for 24 months before getting the 50% deduction. Note also that in order to claim the capital gains exemption, the employee must hold the shares for 24 months after exercise. The examples below illustrate this.

CCPC Example

Eve granted shares of CCPC Co at $1 when FMV $7.

Eve exercises when FMV $11.

Eve's employment benefit $10 (deferred)

50% deductible available only if shares held 2 years.

Eve holds shares 2 years, then shares sold(when liquidity event) at $17

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Eve is granted an option to purchase shares of a CCPC at $1 per share when the fair market value is $7 per share. Eve exercises when the fair market value is $11 per share.

Eve has an employment benefit equal to $10 per share, the fair market value of $11 less the price paid on exercise of $1. However, the $10 employment benefit is deferred. It is only taxable on sale.

Because the strike price was below fair market value at the time of grant, the 50% deduction is not available unless the shares are held for two years following exercise. Suppose Eve holds the shares for two years and then the shares are sold at $17 per share.

Example Continued

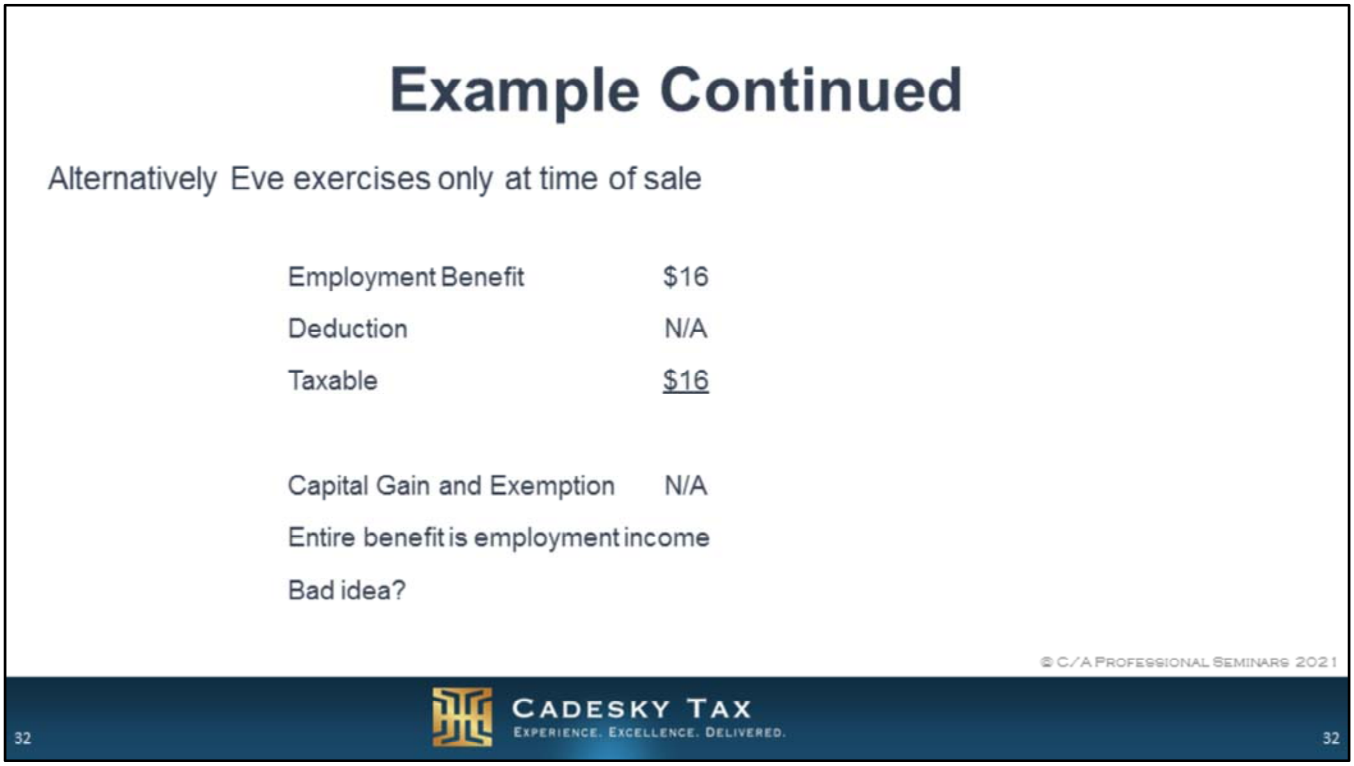
On sale Eve has:

Employment Benefit	$10
Deduction	($5)
Benefit	$5
Capital Gain	$6
Taxable	$3
Exemption	($3)
Income	NIL

On sale, Eve has an employment benefit of $10 per share, and if the two year holding period has been met, then a 50% deduction applies. Eve includes $5 per share as the net result included in income.

Eve then has a capital gain of $6 per share (the increase after exercise) which may, if the company qualifies, be a capital gain exempt under the capital gains exemption.

Eve would be better off to have exercised earlier and have a larger capital gain eligible for exemption.



Suppose instead that Eve exercises only at the time of sale. She does not want to take the risk that the value of the shares could decline after exercise.

This produces a particularly bad result. First of all the employment benefit of $16 is included in income but no 50% deduction is allowed. She did not meet the 24 month holding period. In addition, no component of her gain is a capital gain, and therefore no capital gains exemption is available either. Thus the entire benefit is taxable as employment income with no reduction.

Example Continued

What if Eve exercised and held but CCPC Co went bankrupt.

Employment Benefit	$10
Deduction	(5)
Taxable	$5
ACB	$11
Proceeds	NIL
Capital Loss	$11
ABIL (if conditions met)	$5.50

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On the other hand, consider what would happen if Eve exercised and held the shares but the company went bankrupt. Assume that she met the 24 month holding period. The employment benefit would be $10 and a 50% deduction would be given, so that the amount included in income was $5. Her ACB is $11, and when the company goes bankrupt, her proceeds are NIL. Thus she has a capital loss of $11.

If the corporation was a small business corporation at any time in the 12 months preceding the date of bankruptcy (being the date of her disposition), then she would be able to claim an allowable business investment loss of $5.50, which would eliminate the inclusion in income. She might, in these circumstance, have some amount of alternate minimum tax to recognize. One would have to work out the calculations.

Example Continued

Can apply ABIL as deduction to eliminate net employment benefit.

But may have some AMT, need to calculate.

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What if Eve Leaves

Assume shareholders agreement provides for shares redeemed at FMV on leaving.

Eve has same employment benefit on exercise, deferred until a disposition.

Exercise	$11
Price	($1)
Benefit	$10

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Suppose instead that after exercising, Eve Leaves the company, and the shareholders agreement provides that her shares are to be redeemed for fair market value at $11. Eve would have an employment benefit of $10, and no 50% deduction.

What if Eve Leaves Continued

On redemption, Eve has deemed dividend and capital loss. Assume PUC is nil. Shares redeemed at $11

Deemed Dividend	$11
Capital Loss	$11

ABIL available?

Crazy result! Especially if not SBC.

Better result if shares purchased, not redeemed.

Sometimes plans provide for a purchaser (other employees, major owner or separate corporation)

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On the redemption of her shares, Eve would have a deemed dividend and a capital loss. If we assume that the paid up capital or PUC is NIL, which is probably not a good assumption in the circumstances, the deemed dividend would be $11 being the proceeds of redemption. She would have a capital loss of $11 which might result in an allowable business loss being available.

This gives rise to an odd result.

Employment Benefit	$10
Deemed Dividend	$11
Capital Loss ($11)	

Clearly it is better if the shares are not redeemed, and some stock options plans will provide for a purchaser in these circumstances (possibly a subsidiary corporation or a sister corporation, or possibly a group of other employees or a major shareholder).

Recent Changes

- Employer may deduct the disallowed option benefit amount in computing income
- Contradicts general principle that non-cash amounts are not deductible from income
- Various requirements for the employer claim the deduction, cannot claim if 50% deduction taken

In order for the employer to claim the deduction, it needs to:

1. Decide whether to designate any options as non-qualifying for option grants below the annual $200,000 vesting limit; this determines if the employee or the employer benefits from the tax savings since the employees cannot claim the option deduction if the corporation takes the deduction
2. Notify employees within 30 days after the stock option agreement is granted regarding:
    1. Any options that exceed the vesting limit
    2. Whether it designated any options that do not qualify for the stock option deduction
3. Ensure human resource and tax department compile the necessary information to be submitted to the CRA (it needs to inform CRA of any non-qualifying security granted during the year and it needs to be filed in a prescribed form along with the corporate tax return)
4. Track option grants and exercises and ensure that source deductions are properly taken and remitted
5. Gather non-qualifying securities information to support the corporate tax deduction if one is taken

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With respect to the first point, the employer is able to designate securities that are within the $200,000 threshold in cases where an employer does not want to deal with the cumbersome calculations attached to this deduction. This appears to be an one-sided decision with the employee having no say.

The deduction by the employer is taken under subsection 110(1)(e) of the Act. This amount is basically the **stock option benefit** pertaining to the non-qualifying securities. Using the previous example, the deduction that may be taken by Ann's employer, Canco, is $25 x 46,923 = $1,173,075. Assuming Ontario corporate tax rate of 26.50% this represents a tax savings of $310,864.88. This resembles closely the extra tax that Ann has to pay so in theory these rules are tax neutral to the government but the employees seemed to have received the short end of the stick.

If stock options are surrendered without being exercised, then the employer will make a payment to the employee, which can be deductible to the employer. However, in this circumstance, no deduction may be taken under paragraph 110 (1)(d), the provision which allows the 50% deduction. To the extent that the amount would not qualify for the 50% deduction in any event, or is in excess of the amount of the deduction which can be allowed, it may be beneficial for the employer to purchase back the options, take the deduction, and the employee is no worse off.

Stock Option Summary

	Non-CCPC/MFT	CCPC arm's length
Employment income	Year of exercise	Year of sale
Option deduction	Common shares; many requirements (arm's length); possible $200,000 limitation	2 year hold; exempt from new $200,000 regime
Capital gains exemption	Not available	Need to meet conditions, particularly the 24 month hold
Financial cash issues	Exercise price, withholding; tax payment	Exercise price, withholding; tax payment
Tax risk	Capital loss	Capital loss (but ABIL maybe)

This slide is a summary of the stock option rules, showing the difference between the non-CCPC and the CCPC systems. Note that for the CCPC rules, the employee must deal at arm's length with the corporation at the time the stock option is granted.

Reviewing the above, although the standard stock option taxation regime allows for a "capital gain" like result there are multiple hurdles to meet and various practical issues to resolve. With the new $200,000 regime there are now more disincentives to issue stock option as a remuneration alternative to attractive skilled workers. Although the government appears to be close to tax neutral if the employer takes a deduction on the option benefit that the employees cannot be deduct, the employees have the most burden with this change.

The following slides provide some alternatives that employers may consider to use for employees to achieve similar results compared to the standard stock option plan. Note that these plans are general concepts that may only be suitable in specific circumstances. Each plan has various challenges and should not be implemented unless thoroughly examined.

Conclusions

Stock option rules can be very beneficial if all goes well.

But can produce adverse results if price declines.

Leads to development of various new and creative ideas.

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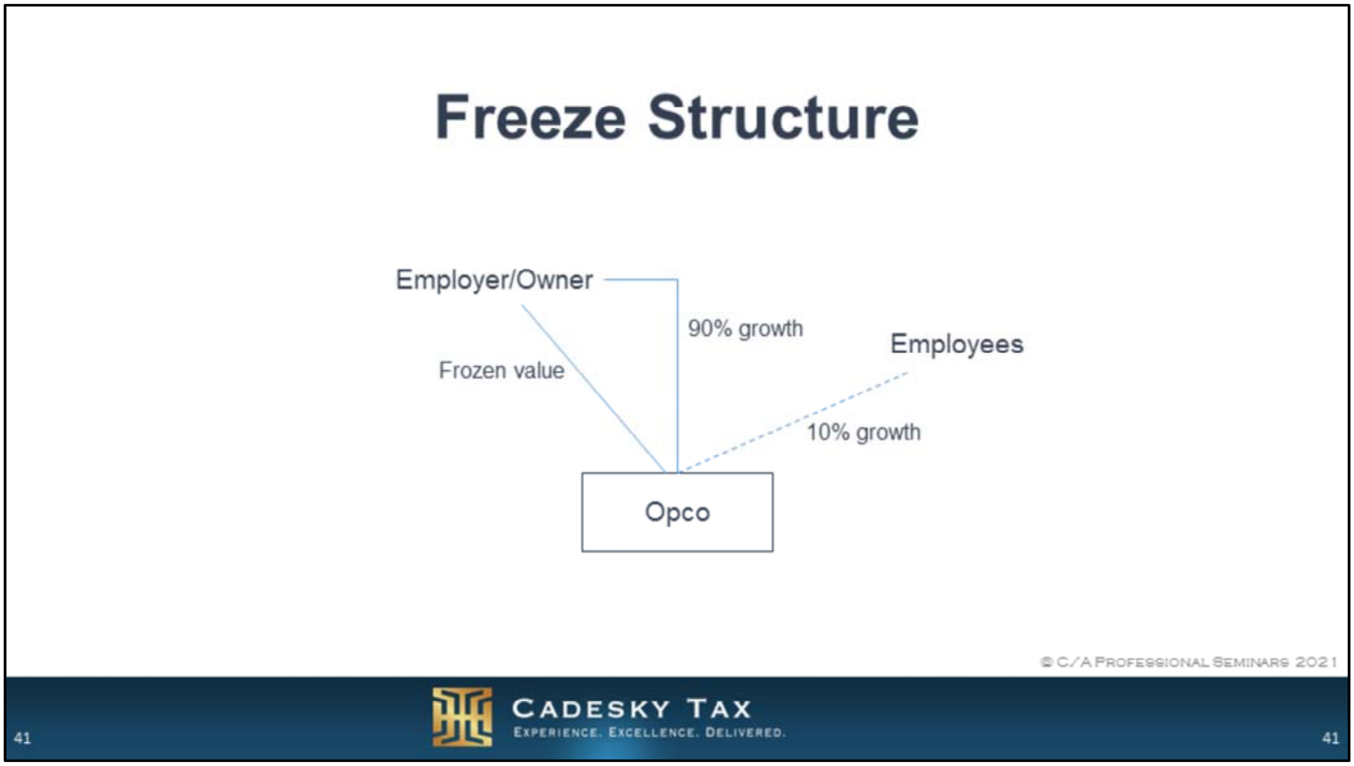
The stock option rules can be very beneficial if everything goes well. The rules typically favor an early exercise and hold, however this is risky because of the way the rules operate. An adverse result can occur for tax purposes if the price declines after exercise. Because of this, various alternative plans have been developed and these are explained in the slides which follow.



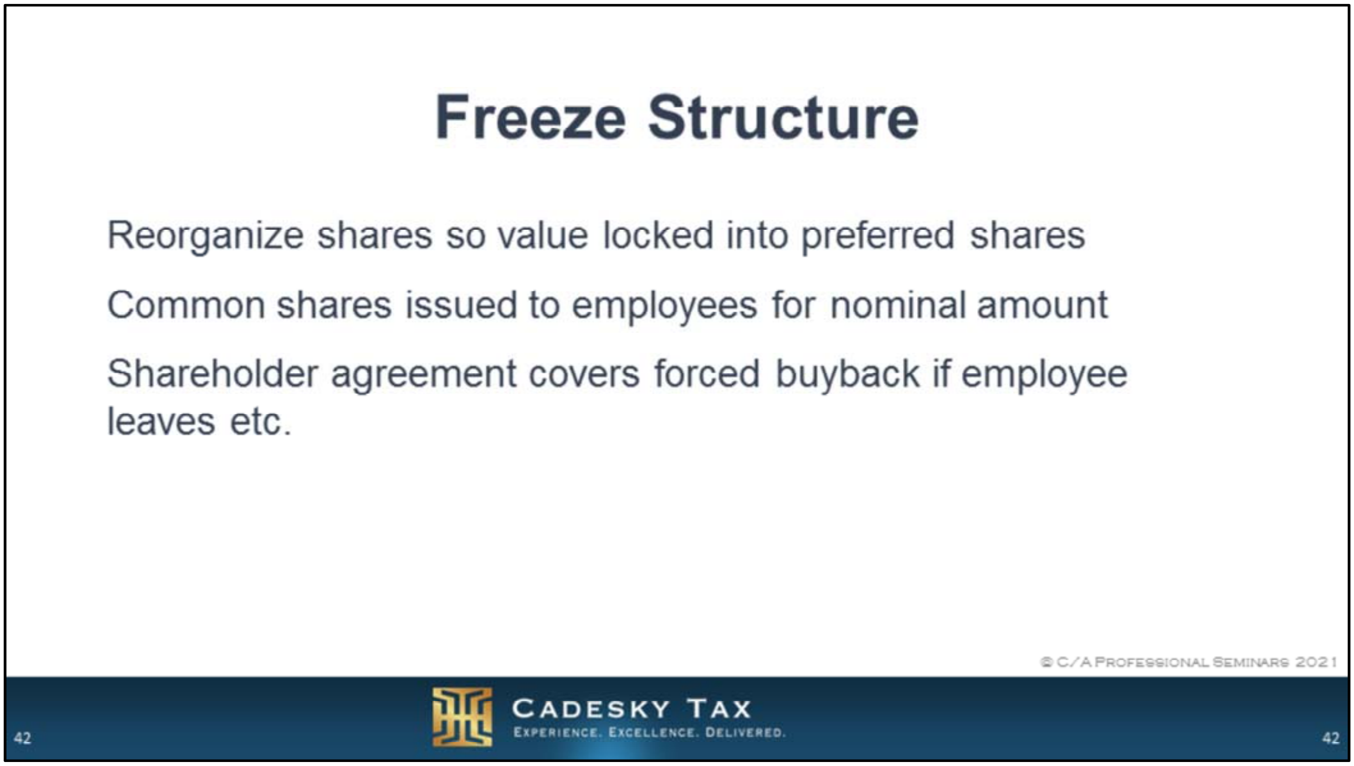
In this alternative, the employer/owner will undertake a vanilla freeze transaction. The major owners and the employees will then subscribe for new growth shares. This is the same technique as an estate freeze. If the plan is to have a "vesting period", it is possible to undertake a further freeze at each vesting time and each parties will subscribe for new growth shares, but this may not be practical.

Under this plan it is possible to argue the employees obtain the shares as a result of the employment. While this is possible, there should be minimal employment income inclusion, since a freeze generally traps all the current value to the existing shares so new growth shares have nominal value. The employment income inclusion may be more if there are multiple vesting periods and a second round of freeze is not undertaken. No cash flow problem for source deductions. It may still be argued that this arrangement falls under section 7 of the Act, as the language only refers to an agreement for the employee to purchase the stock of the employer (or an non-arm's length entity) but even if this is the case, the valuation is nominal.

If the shares could qualify for the CGE, then the employees need to satisfy all the conditions (e.g. 24 month holding period). This does not change from the standard option plan.

Shareholders' agreement may need to be put in place to govern employee departure, buyout, valuation of buyout price, etc.

Administratively this may not be an attractive option if employee participation vests over time as we need multiple freezes and possibly multiple classes of shares to ensure minimal tax issue for the employees. If further freezes are not undertaken and the employee shares have accumulated value, the employees will need to pay FMV for the new shares to avoid an employment benefit. This will be suitable for situations where the employer wants to bring in only a selected few employees for a one time participation. Quite suitable for private businesses.



In carrying out the freeze structure, the following steps would be done:

1. Opco would be valued
2. The shareholders of Opco (the major owner) would exchange their common shares for preferred shares with fair market value.
3. Both the existing owners and the employees would subscribe to new common shares, typically for a nominal amount because this would be the fair market value.
4. A shareholders agreement will cover the situation of a buyback if the employee leaves etc.

This transaction is normally done only for private companies, but it could be carried out within a public company group using a subsidiary corporation, and issuing shares which are exchangeable into shares of the public company. However, typically it is with CCPC's that one sees this kind of planning.

Freeze Structure

Benefits

- Employee has shares not options so no employment benefit issues
- Starts 24 month period for capital gains exemption
- No tax risk if decline in value
- Nominal payment

Drawbacks

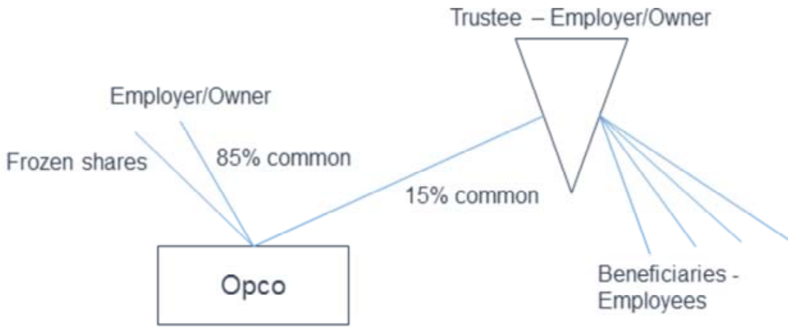
- Buyback at nominal value could be contested
- Less control on issues like vesting
- No cash contributed, little "skin in the game"
- Employee has hurdle of preferred share value, may be demoralizing

There are several benefits to the employee from this structure. The employee has shares immediately and not options, so no employment benefit issues arise, provided the common shares are issued at fair market value. The issuance of the common shares starts the 24 month period for purposes of the capital gains exemption. There is no tax risk if there is a decline in value at later time, because the common shares simply become worthless, there are no tax implications. Lastly, there is no withholding on the stock option benefit, and the payment made by the employee is nominal.

There are however some drawbacks. Firstly, it is possible that a shareholders agreement which results in a buyback of the shares at a nominal value could be contested on the basis of oppression of minority rights. Legal counsel would have to be consulted as to whether or not this was a significant risk. The company will have less control over the employees, because of the reverse vesting arrangement, than would be the case with unvested stock options which could simply be cancelled.

If an employee has not contributed anything for the shares, the employee has little "skin in the game" and may be inclined to give up more easily, if the company has financial difficulties or simply if it is believed that the common shares will not rise in value as anticipated. Lastly, the employee stands behind the value of the preferred shares, which may be demoralizing and not very motivating.

Trust Arrangement



Instead of a corporation, it is possible to create a trust for the benefit of the employees who are entitled to the incentive plan. Generally under this plan the trust would own a percentage of the company and the benefit will accrue to the employees over time. The trustees will have discretion on distributions. The trust terms may be drafted such that if an employee leaves the company, said employee will cease to be a beneficiary.

Under this alternative, there is no cash outflow for the employees and can be structured so that the employer/owner does not need to provide much cash (e.g., using a freeze strategy). However, the trust must still meet the 24 month holding period test to qualify for the CGE (for this purpose, the time period during which an employee is a beneficiary of the trust will count towards the 24 months). As there is no agreement for the employees to purchase shares, the entire stock option regime should not apply.

Care should be taken in drafting the trust agreement as it should not be classified as an employee trust or employee benefit plan since distributions from these trusts could be taxable as employment income to the employees. The flip side is that the trustee needs to be cognizant of the 21 year rule and take steps to address the deemed disposition event. Usually, this may be avoided by distributing the shares of the company to the employees.

Sometimes this is done on start up of the company, but it can also be done using the freeze arrangement. Typically the shares are issued to one of the major owner, who gifts the common shares to the trust for the employees.

Trust Arrangement

- Similar to freeze structure but shares issued to a trust
- Beneficiaries are defined as a class – employees, employees at a certain level or term of employment
- Discretionary allocation by trustee among employees
- Could fix entitlement, vest or partially vest entitlement in beneficiaries
- If employee leaves, drops out of beneficiary class

It is important in the construction of this arrangement that the trust not subscribe directly to the shares. Instead, the shares should be issued to an individual who gifts the shares to the trust. If done through a freeze, no gain or loss should arise on the transfer to the trust.

The beneficiaries are typically defined as a class being either all employees, or employees who are at a certain level or have been with the company for a certain term of employment. It is very important that all of the beneficiaries of the trust be ascertainable at all times by the trust. If not, the trust could be void.

The employees obtain a discretionary allocation based on the powers given to the trustee. This could be a fixed entitlement, or a vesting of an entitlement or partial vesting from time to time.

If an employee leaves, than that person simply ceases to be part of the class of beneficiaries.

Trust Arrangement

Benefits

- As with freeze structure
- More control on vesting, allocation etc.

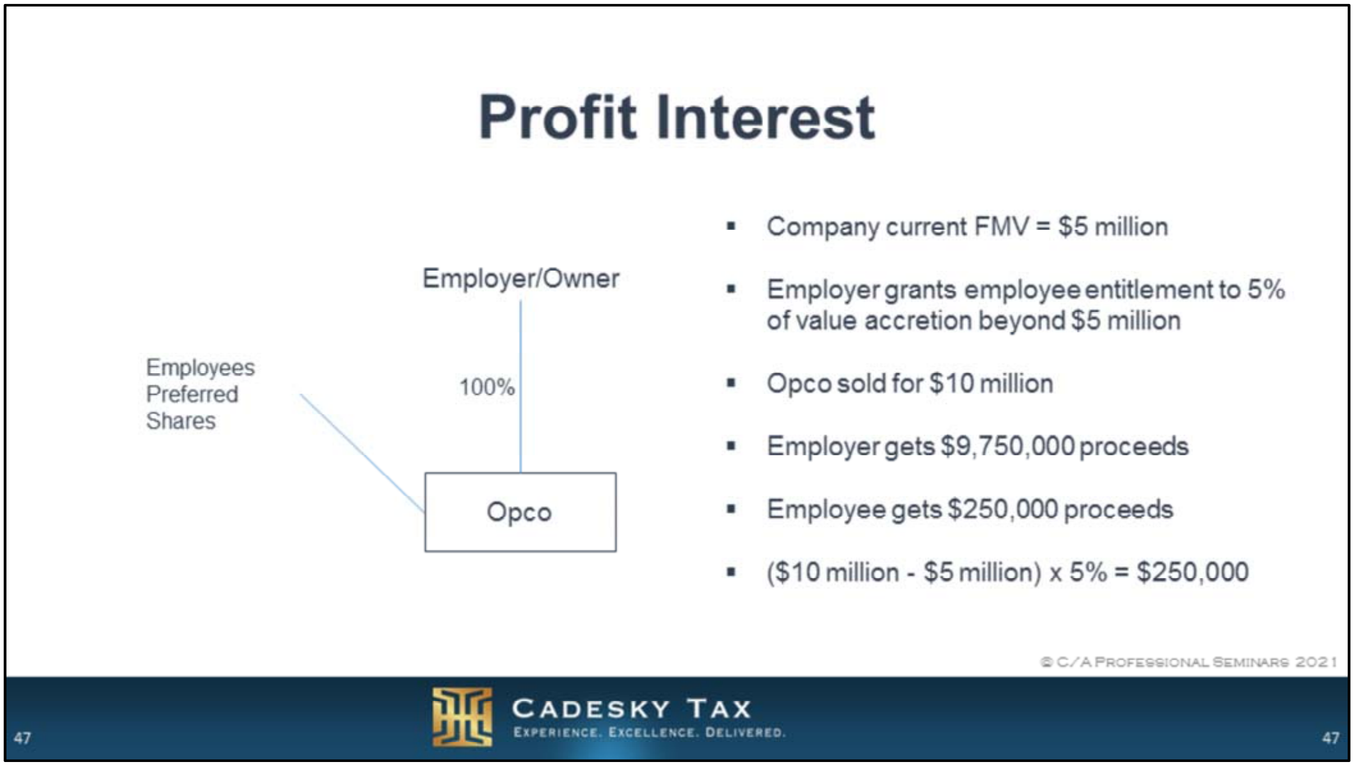
Drawbacks

- Must be able to identify beneficiaries at all times or trust void
- Employees do not get a "piece of paper", more remote than owning shares
- Care needed in structure set-up

There are a number of benefits with this structure. In addition to all of the benefits listed under the freeze structure, more control is given over the shares, through the discretionary allocation allowed via the trust. The employees can be given a general indication of what their entitlement will be from time to time, or this can be made binding through the trustees resolving to vest an entitlement under the trust in them, even though the shares may still remain in the trust.

In terms of drawbacks, the most significant is to make sure that the trust is constructed properly, and that the beneficiaries can be identified at all times. Another important requirement is to make sure that the trust does not trigger the reversionary issues of subsection 75(2), or else the major shareholder, for example, who created the trust might be taxable on all of the gains. Thus care needs to be taken as to who the beneficiaries are.

This type of arrangement is more abstract than with a stock option plan or a share issuance plan, and the employees may be skeptical and not understand the terms of the arrangement. Thus if one of the purposes is to motivate the employees, this structure could be challenging. A great deal of care has to be taken in exactly how this structure is arranged, and the trust must stay clear of a number of specific rules in the Income Tax Act (i.e. not be an employee trust or an employee benefit plan as defined).



This strategy is sometimes used by U.S. entities to compensate employees usually in situations where the operating entity is a partnership (or an LLC treated like a partnership under U.S. law). A corporation may be able to utilize this type of arrangement as well.

The basic flow of the strategy is that the employer grants an employee a profit interest of X% of the employer based on a certain threshold. This can be based on the value of the employer or some other criteria such as revenue or EBITA. Vesting can be time based or performance based. As this arrangement does involve an agreement to purchase shares the stock option rules have application but the value is nil or nominal.

One may argue that the profit interest is a capital property because it is a share. On the other hand, it is possible to say that the employee only receives this profit interest by virtue of employment and thus the proceeds should be employment income. In addition, if the vesting conditions are driven by performance of the employee or the company it may be viewed as a form of bonus or earnout to produce regular income.

While the lack of clarity may be unattractive, it provides employers the flexibility to structure its compensation strategies. For example, an employer may want to provide senior executives more incentive to stay long term and contribute to future growth so the profit interest arrangement may be drafted towards capital treatment with vesting/surrendering conditions.

In the US, it has become popular to construct arrangements by way of a so called profit interest. In this arrangement, the shares held by the employee only have a value if the company is worth above a certain threshold amount. It may not be practical or feasible to carry out a freeze type arrangement, as shown previously, and therefore carrying out what amounts to a reverse freeze with a profit interest could be a solution.

Assume that the company is worth $5 million today the company grants the employee an entitlement of 5% of the increase in value above the current value of $5 million. The employee immediately subscribes to these preferred shares.

Suppose the value of the company increases to $10 million and it is sold. The employee picks up $5 million of value through the preferred shares, multiplied by the percentage entitlement, here 5%. Thus the employees shares are worth $250,000 being the 5% increase. This should be a capital gain.

Profit Interest

New class of shares created with special terms (Profit Interest Shares). Profit interest shares only have value if company (or common shares) worth over a Threshold value.

Works like a freeze in reverse.

Can issue many classes with different Threshold Value.

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To create this arrangement, a new class of shares is authorized by filing articles of amendment. These shares can be called the profit interest shares, or simply labelled as a class of preferred shares. They have a value only above a threshold amount, as defined. Essentially this works like a freeze in reverse. To answer the question of employees joining at different times, various series of preferred shares can be created at different threshold amounts. The important point is that when the preferred shares are issued, they should have either no value or a minimal value created only by virtue of their optionality.

Profit Interest

Benefits

- Works like freeze structure
- No material cash contributed
- No (or minimal) employment benefit
- Could work in larger companies where freeze not practical

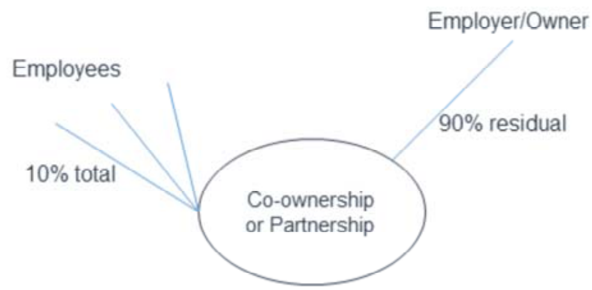
Drawbacks

- Similar to freeze structure

The benefits are the same as with the freeze structure. No material amount of cash is required from the employee. There is no employment benefit. The shares may also be eligible for the capital gains exemption once held for 24 months.

This can work well in larger companies where a freeze would not be practical. It can also work well in circumstances where the 50% deduction would not be available due to the $200,000 limit, and for this reason it has become popular in Canada. While there are good reasons to believe that this structure works as intended, CRA does not have a published view on the arrangement. It is unlikely, but theoretically possible, that CRA could try to challenge the arrangement on the basis that there is an employment benefit. If so, the question would become the value of the employment benefit, which might be argued to be NIL or something nominal representing only the option value of the preferred shares.

Co-ownership or Partnership



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This strategy is straightforward. The employee basically has an ownership in a co-tenancy or partnership with the employer. The terms of the partnership agreement may dictate the rights of the employees (e.g., restrictions on making decisions, etc.).

Under this scenario, the CGE is not available although it may be possible to restructure the operations prior to an exit event to convert the operations into a corporation.

This structure is created separately to the main operating company, and involves either a co-ownership or a partnership which carries out a particular project. It is particularly suitable to real estate investment.

Co-ownership or Partnership

Employees allowed to participate in a real estate project or business segment. Done alongside operating business.

Can be a GP or carried interest

Popular in private equity funds

(e.g. 2 and 20 funds)

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The employees are allowed to participate in the real estate project, or some business segment or opportunity. This is done alongside of the operating business. The arrangement can be carried out through a partnership or a co-ownership. A more defined version of this arrangement is used in private equity funds, described later.

Co-ownership or Partnership

Benefits

- Produces capital gains treatment (flow through)
- Minimal cash needed
- Avoids employment income and stock option treatment
- Could combine with a trust

Drawbacks

- Often long time period before a return arises
- Other issues as per freeze structure
- Could be personal liability

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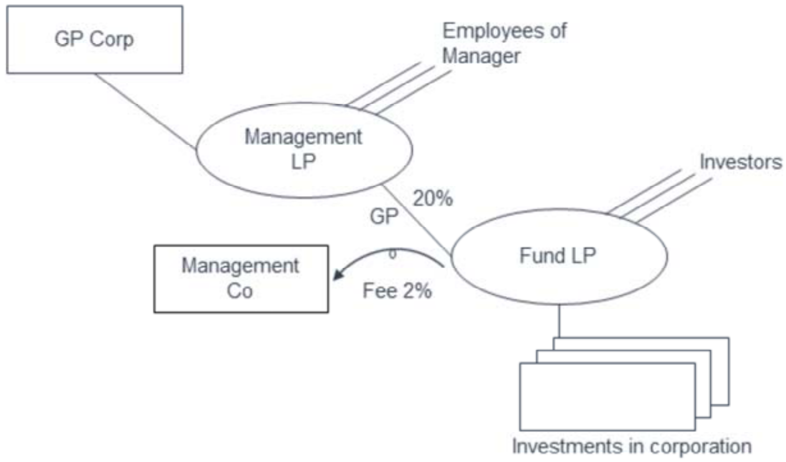
This arrangement is designed generally speaking to produce capital gains treatment, if a capital gain results, or business income treatment if business income is earned (including from land development). The arrangement can be structured so that the employees contribute a relatively minimum amount of cash. It avoids employment income and stock option treatment. It can also be combined with a trust. Certain employees might chose to hold their interest in the co-ownership or partnership in a corporation, especially if there will be active business income.

There are a number of potential drawbacks. One is that the arrangement may be of a long term nature, which does not provide an immediate return to the employee. Another is that participation in the arrangement could give rise to personal liability, even if a limited partnership is used, because the employee might be viewed as materially participating in the limited partnership.

Private Equity Structure



Above a set return to Investors, Management LP gets 20% of gains

This arrangement is common in structuring private equity funds. There are typically two partnerships, the fund partnership called Fund LP and the management partnership called Management LP. Management LP holds a general partner interest in Fund LP. Suppose the fund is structured as a typical 2 and 20 fund. 2% is the management fee paid to the management company, which employees the employees in the private equity fund. The investors invest in Fund LP, contributing equity. Sometimes the employees will also participate as investors in Fund LP. Fund LP makes investments typically in private businesses, in the hope that they will increase in value and that there will be a realization on sale.

Management LP holds a 20% carried interest in Fund LP. This only becomes worth something after the investors have received a specified return on their investment. Thereafter, Fund LP allocates 20% of gains to Management LP and the balance to the investors. Typically it is towards the end of the fund (often 5-7 years later) that the GP interest in Fund LP has a value. Management LP allocates the gains to the employees who are limited partners in Management LP.

Private Equity Structure

Produces flow-through of capital gain via partnerships

Allocation among partners at Management LP level can be discretionary or fixed by partnership agreement (but can be adjusted by CRA in unreasonable)

Best to establish at inception

Can bring in new partners later if GP interest has low value.

The structure is best set up at the inception of the fund. However, new partners can be admitted, for a nominal amount in Management LP provided the GP interest does not have any material value. If it does have a material value, then the granting of an interest in Management LP would likely be employment income as a benefit in kind.

The idea is that capital gains from the sale of the underlying companies are allocated through the partnerships to the employees who obtain capital gains treatment. The allocation of these gains to the employees could be governed by the partnership agreement, could be discretionary based on the awarding of allocations by a compensation committee, or there could be a trust above which allocates the amounts among the various employees. Note that at the present time CRA has not indicated that it would challenge these types of arrangements, provided the allocation among the partners of Management LP is reasonable. If it is unreasonable, then CRA does have the power to reallocate. In general, as long as the allocations are proportionate among the various partners, it is not likely that CRA would alter the allocations. But if capital gains and losses were split, so that some participants obtain capital gains and others capital losses, or the capital gain exemption was channeled to only certain people (say residents and not non-residents), then a challenge could be expected.

Private Equity Structure

Benefits

- Nominal investment by partners in Management LP
- Capital gains treatment, not employment income
- May have SBC share sale and capital gains exemption

Drawbacks

- Could have personal liability (LP does not protect active partners) Some complexity.

There are several benefits to the structure. Firstly, the partners in Management LP do not need to pay a material amount for their partnership interest. Secondly, capital gains treatment should result rather than employment income. Thirdly, if a capital gain results in Fund LP which is eligible for the capital gains exemption, than this should carry through to the employees.

One drawback is that the employees could have personal liability, because even though Management LP is a limited partnership, the employees could be viewed as materially participating in the business and hence lose limited liability protection. In addition, there is complexity in establishing this arrangement. Nevertheless, it has become very popular and is commonly used.

Summary

- New stock option plan rules taxing on employees
- Various alternatives to standard stock option plan
- Some plans better in some situations
- Careful planning required

Stock options provide a very good way to give employees an incentive, and can be very tax efficient. However, they come with a large number of risks, particularly where an employee exercises a stock option and continues to hold the shares. The more creative arrangements are designed to work around this issue producing capital gains which by-pass the stock option rules.

Being familiar with these rules and plans is perceived as a high value service.