Canadian income taxation of equity compensation and Income Tax Act implications

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Many U.S. companies allow Canadian-based employees to participate in their equity incentive compensation plans. However, the Canadian tax treatment of commonly granted equity compensation awards is very different than in the U.S. This legal primer provides an overview of the tax implications under the *Income Tax Act* (Canada) to both the employer and employee of the following awards:

- Stock Options;
- Restricted Stock;
- Restricted Share Units (RSUs) and Performance Share Units (PSUs);
- Deferred Share Units (DSUs); and
- Share Appreciation Rights (SARs).

Note that this primer is a general summary and is not intended to address all variations and implications of these compensation awards. It applies to employees, officers and directors, but does not apply to awards granted to consultants, independent contractors or other non-employee service providers.

Stock Options

These rules apply to options granted by corporations or mutual fund trusts. Provided the stock options are granted with an exercise price at least equal to fair market value (FMV) of the optioned share as at the date of grant (which is generally the date the Board of Directors approves the grant unless the Plan provides otherwise). The tax implications are:

- Upon exercise, the employee will receive a taxable employment benefit equal to the difference between the exercise price and the FMV on the exercise date;
- The general rule is that the full amount of this taxable benefit is included in income and subject to tax in the year the option is exercised and shares are acquired. However, in certain circumstances the benefit may be reduced by 50 per cent (*i.e.* only half of the benefit will be taxable to the employee). This deduction is available if all of the following requirements are met:
    - the exercise price is not less than the FMV of the share at the time the option was granted;

- the employee was dealing at arm's length with the employer immediately after the option was granted to him; and
- the share on which the option is granted must be a "prescribed share", which in essence means a "plain vanilla" common share that has no special guarantees, rights or features either under the corporation's articles or by virtue of any agreement in respect of the share.

Although stock options are beneficial to the employee, no deduction is available to the Corporation (or any non-arm's length person) for the issuance of shares on the exercise of a stock option, or for a cash out of a stock option where the employee receives the 50 per cent deduction.

Stock bonus arrangements (where the employee is paid a bonus in the form of securities issued from treasury where the employer has a legally binding obligation to issue the securities and the employee has an enforceable right to be issued the securities) generally have adverse tax consequences and are rarely used in Canada. The employee will be fully taxable on the FMV of the shares when received; however, the employer is not entitled to any deduction.

Effective July 1, 2021, stock options eligible for the 50 per cent deduction (other than options granted by Canadian Controlled Private Corporations, start-ups, or emerging and scale-up companies) will be limited to the annual cap of $200,000 calculated on the fair market value of the underlying shares on the date the options were granted. To the extent the stock option benefit is not available to the employee, the employer will be entitled to a corresponding deduction.

Restricted Stock

Restricted Stock is issued to an employee subject to forfeiture if certain conditions are not met. These awards can have adverse tax consequence and are rarely used. The employee is taxable on the value of the stock upon issuance. If the stock is later forfeited, no deduction is available to the employee. Further, no tax deduction is available to the employer.

Restricted Share Units (RSUs) and Performance Share Units (PSUs)

RSUs that are cash-settled (or settled in cash or stock at the option of the employer) are widely used in Canada. To avoid immediate taxation, these types of awards must be designed to avoid the salary deferral arrangement (SDA) rules. The SDA rules cause the value of the amount to be taxed to the employee in the year the award is granted, not in the (later) year in which the right vests or amounts are actually received. One of the most frequently relied upon statutory exceptions to the SDA rules is the Three Year Bonus Exception. For an award granted in respect of services rendered in 2020 (Service Year), the award must be settled and paid by Dec. 31, 2023. Note that the Service Year may not be the year the award is actually granted, as it is common for awards to be granted as part of a performance review process in respect of the prior year. The deadline is absolute with no exceptions, which can make plan design difficult when trying to align with competing US rules (such as 409A requirements).

PSUs may also avoid the SDA rules if there is a “substantial risk” that one or more conditions attached to the award will not be met. The risk of forfeiture must be definite and substantial and is a very high threshold. If the performance target is likely to be fully or partially met, this exception would not apply. Therefore, most PSUs are structured so as to fit within the Three Year Bonus Exemption described above.

The employer can deduct the payment in the year paid. Note, if the award can be settled (at the option of the employer) in either cash or stock, jurisprudence has confirmed that the employer may deduct the payment.

Deferred Share Units (DSUs)

A DSU is a bonus plan that is also exempt from the SDA rules by virtue of qualifying as a prescribed plan or arrangement. DSUs have the following requirements:

a. There must be an agreement between the recipient and the employer (or related corporation) pursuant to which the recipient becomes entitled to DSUs;
b. The DSUs must reasonably be attributable to duties of an office (including directorship) or employment performed by the recipient;
c. All amounts that may be received under the arrangement must be received after the time of the employee’s death, retirement or loss of the office or employment and before the end of the first calendar year commencing thereafter;
d. The amount paid to the employee must depend on the fair market value of the shares of the employer corporation or a related corporation. This fair market value must be determined at a point in time between one year before the death, retirement or loss of employment (as the case may be) and the date the payment is made; and
e. The DSU cannot guarantee a minimum value to an employee.

Employees are fully taxable when DSUs are settled and employers are entitled to deduct DSU payments when paid. It is important that the employer not set aside amounts to specifically fund the DSUs, as this segregation of funds could constitute a retirement compensation arrangement and be subject to a refundable 50 per cent tax.

Share Appreciation Rights (SARs)

A SAR awards the recipient with the right to receive a payment equal to the increase in share value from the date of grant to the date of exercise. The Canada Revenue Agency has administratively accepted that where the award settlement amount payout is based on increase in share value from date of grant, the award will avoid the SDA rules. SARs generally are taxable to the employee in the year they vest. The employer is entitled to a deduction.

For all equity based compensation awards, the employer may be required to deduct, withhold and remit tax and social security (*i.e.* Canada or Québec Pension Plan and Employment Insurance premiums) amounts and report the award on the employee’s T4 slip for the year.

For additional resources on Canada's legal concepts from a U.S. business and technical perspective, view our U.S. Perspectives from Canada's Law Firm legal primer series.

If you're a foreign company with operations in Canada wanting to adapt your existing global equity plan for Canadian employees or a Canadian business considering adopting an equity plan, reach out to Pamela Cross or any of the key contacts below to discuss your particular compensation situation.

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