Tax Efficient Compensation Strategies

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Compensation

Compensation encompasses anything constituting consideration for services rendered, including:

- salary and wages
- group insurance benefits wholly or partially paid by employer (e.g., life, extended health, disability)
- non equity-based deferred income plans (e.g., three year bonus plans)
- equity-based deferred income plans (e.g., employee profit sharing plans, stock option plans, phantom stock plans, restricted stock unit plans, deferred stock unit plans, stock appreciation rights plans)
- retirement arrangements wholly or partially paid by employer (e.g., registered pension plans, deferred profit sharing plans, supplementary executive retirement plans, retirement compensation arrangements)

EPSP

Employee Profit Share Plan (“EPSP”)

i. What is it?
ii. Tax Implications
iii. Reporting requirements
iv. Planning opportunity - Example

EPSP

What is an EPSP?

i. Defined in the ITA
ii. Established by way of an agreement
iii. Contributions to EPSP based on profits of Company
iv. Draft Agreement to provide flexibility

EPSP

Tax Implications and Reporting

i. Employer: Contributions made in year or 120 days after y/e deductible
   - No withholding required

ii. Plan Trustee: Must allocate contributions, income, capital gains/losses to participants

iii. Employee: Subject to tax in respect of contributions made in the year and amounts allocated

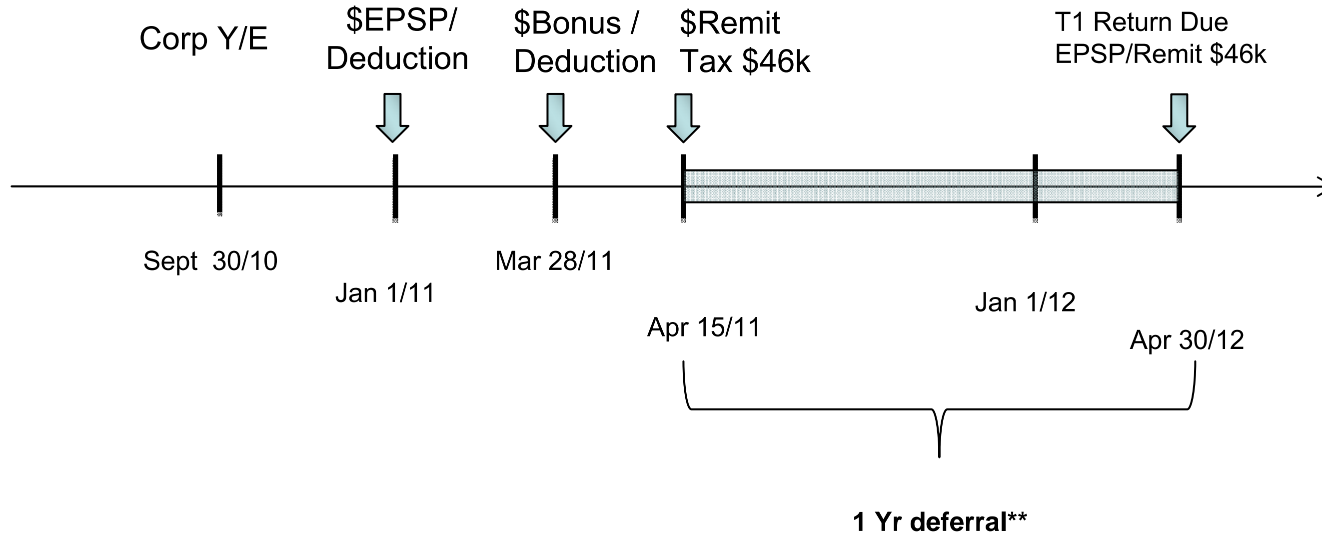
iv. Annually need to file T4PS information return

EPSP

Example Bonus vs. EPSP

i. Assume Bonus/EPSP of $100,000

ii. Personal Tax rate of 46%



EPSP

Summary

i. Flexible
ii. Low complexity and compliance-less costly
iii. Provides deferral compared to bonus
iv. Possible income splitting

Stock Option Plans

In thinking about the tax nature of an equity-based plan, the first major determination to be made is whether it qualifies under s. 7 of the Income Tax Act (ITA)

If it does not, it may be subject to the “salary deferral arrangement” (SDA) rules

Stock Options- Basic Rules - Pre Budget 2010

(Canadian Public Company and Non-CCPCs)

Employees

- Employees not taxable at date of grant
- Employment income on exercise
- Stock option deduction may be available
  1. Grant price at ≥ FMV
  2. Common shares
  3. Arm's length test
- Benefit ineligible for special capital gain rules

Employers

1. No deduction to employer

Stock Options- Basic Rules- CCPC Options

- Same calculation of gross taxable benefit
- Eligibility for 50% deduction based on:
  i. Public Co criteria or
  ii. Held the shares for two years
- Benefit not reported until shares sold (as opposed to date of exercise)
- If two-year retention an issue, need to set exercise price = FMV at time of grant

Stock Options- 2010 Federal Budget Changes

- Stock option cash-outs
- Elimination of public company stock option taxable benefit deferral
- Relief for Underwater stock option shares
- Employer withholding requirements

Stock Options - Cash-outs

- Plan allows for employee to receive a cash payment equal to value of options
  i. Typically a stock option offered in conjunction with a stock appreciation right – Exercise one and the other cancelled
- Receive cash instead of purchasing shares
- Not the same as cashless exercise – where shares are acquired
- Implications for applying stock option rules

Stock Options - Cash-Outs

- "Cash-outs" of qualifying stock options were 100% deductible to corporate employer and often only 50% taxable to employee
- Effective March 4, 2010, employer must now elect whether to claim corporate deduction or to allow employee to claim 50% deduction (and forgo corporate deduction)

Stock Options – Cash Outs – Comparisons

	Pre-Budget	Post-Budget	
	Cash-Out	Cash-Out with Election	Cash-Out No Election
Employer Cash Paid Tax Savings	$100 (30)	$100 ---	$100 (30)
Net After-Tax Cost – Employer	$ 70	$100	$ 70
Employee Cash Received	$100	$100	$100
Less Stock Option Deduction	50	50	---
Taxable Income	50	50	100
Tax thereon (at 46%)	23	(23)	(46)
Net After-Tax Proceeds to Employee	$ 77	$77	$ 54

Stock Options – Cash-Outs – Implications

- Existing plans Tax benefits reduced
- Accounting (for expense and tax charge) can be simplified
- Employees incented to sell stock
- Employees may need a broker to facilitate exercise and sale
- If no agreement to issue shares, must be designed to avoid SDA rules

Stock Options – Cash-outs – CCPCs

- Taxable benefit to employee when cash received
- 50% deduction needs exercise price to ≥ FMV at date of grant
- Budget does not distinguish between type of options re cash-outs (i.e., public, CCPC, other private)
- Post-budget, employee only enjoys 50% deduction if employer forgoes deduction and criteria met
- Employees still enjoy tax-effective treatment if employer doesn't need deduction (i.e., start ups, losses)

NOTE: For Other Private Companies: Same rules apply as for public companies

Stock Options - Elimination of $100,000 Deferral

- Prior law –
  - i. Election to defer income from exercise of stock options until sale
    - i. When sold there will be compensation from employment plus capital gain/loss
  - ii. Limited to $100,000 of value of shares at grant for each year of vesting
- New law – deferral election no longer allowed for options exercised after 4 pm (EST) on March 4, 2010

Stock Options - Underwater Stock Option Shares

- Mechanics of special election
- Taxable benefit deemed to be a taxable capital gain
- Employee applies actual capital loss to deemed taxable capital gain
- Pays special tax equal to actual proceeds received
- Capital loss unavailable for other gains in other years
- Employee must dispose of shares before 2015
- Elections permitted for previous 10 years – due April 30, 2011

Stock Options - Withholding Tax Requirement

- Public and non-CCPC
  i. Employer must withhold (from all sources) and remit tax on value of stock option benefit realized in a given period, starting after 2010
- CCPCs-Tax not due until shares sold
- Consistent with U.S. provisions
- Undue hardship-still available

Phantom Stock Plan

Plan that is not subject to s.7 usually structured to avoid SDA rules

Premise is that employees are taxed on employment income when received

SDA rules act as anti-avoidance measure to discourage referral of employment income

Upon characterization as an SDA, deferred amounts are added to income as of when the right to receive them arises

For characterization as an SDA to occur:

- employee must have right to receive amount after end of the year
- reasonable to consider that one of the main purposes for the right is to postpone income tax
- amount is in respect of salary or wages for services rendered in year or previous year

Deferred Bonus Plan

The following is specifically excluded from ambit of SDA rules:

- plan under which employee has right to receive a bonus or similar payment
- bonus is in respect of services rendered in a taxation year
- bonus is paid within 3 years following end of calendar year to which services relate

This type of plan is quite common and is often referred to as a long term incentive plan

If funded, is an “employee benefit plan” (EBP)

Restricted Stock Unit Plan

This is a type of deferred bonus plan that serves as either:

- a replacement for a stock option plan
- the Canadian version of a US style RSU

Typically:

- bonus amount is “converted” to “restricted stock units” (RSUs) by dividing amount awarded by market price of share
- at end of vesting period, employee receives either one share per RSU or cash determined by multiplying RSUs by market price of share at that time

If shares are issued, is a s. 7 plan. If funded, is an EBP

Tax Positions re Deferred Bonus Plan

For employee:

- amounts taken into income when become vested

For employer:

- entitled to deduction at end of vesting period
- usual source withholdings apply

Employee Benefit Plan

EBP generally defined as an arrangement under which:

- contributions are made to a “custodian” by employer or person not dealing at arm’s length with employer
- one or more payments are made by custodian to or for benefit of employees, former employees and persons not dealing at arm’s length

Contributions must be reasonable

No restrictions on investments

Most EBPs are structured as trusts

Tax Positions re Employee Benefit Plan

For employee:

- all amounts received out of an EBP, other than if contributed by employee, treated as employment income regardless of source (capital gain or dividend)
- employee contributions not deductible but received tax free

For employer:

- employer contributions not deductible until included in employee's income
- final deduction available if plan obligations are satisfied and no plan property will be returned to employer. (This is relevant if value of EBP property declines before amounts are paid to employees)

Tax Positions re Employee Benefit Plan

For custodian:

- EBP trusts subject to *inter vivos* trust rules, therefore retained income taxed at flat rate equivalent to highest marginal rate for individuals
- where amounts are taxed in the trust, are taxed again in beneficiaries’ hands
- trust may deduct from income distributions to beneficiaries and expenses related to investment activities and to normal operation of trust
- usual source withholdings apply

Deferred Stock Unit Plan

The following is specifically excluded from ambit of SDA rules:

- arrangement between employee and employer under which payments reasonably are deferred until no later than end of calendar year following termination or death
- amount to which employee is entitled is dependant on FMV shares determined no later than time the amount is received and no earlier than one year before termination of death
- arrangement does not entitle employee to any amount or benefit for purpose of reducing any reduction in FMV of shares

Deferred Stock Unit Plan

Typically employee is credited with notional “deferred stock units” (DSUs) in respect of percentage of yearly employment income

May also be credited with:

- dividend equivalents in form of additional DSUs to mirror ordinary course cash dividends
- adjustments in the event of stock dividend, consolidation, exchange or other changes to shares

Typically:

- annual statements are provided
- DSUs are redeemable for cash or shares purchased on open market, or from treasury (in which case it is a s. 7 plan)

Tax Positions re Deferred Stock Unit Plans

For employee:

- cash amounts paid in satisfaction of DSUs taken into income when cash received
- amounts paid to acquire shares on open market (including brokerage fees) taken into income when shares received
- amount representing aggregate FMV of treasury shares issued taken into income when shares received (s. 7 plan)

Tax Positions re Deferred Stock Unit Plans

For employer:

- cash amounts paid in satisfaction of DSUs deductible when taken into employee’s income
- amounts paid to acquire shares on open market deductible when taken into employee’ income
- amount representing aggregate fair market value of treasury shares issued not deductible (s. 7 plan)
- usual source withholdings apply

Stock Appreciation Rights Plan

Plans providing payments based solely on appreciation of units from date of award to time of unit redemption are not subject to SDA rules because considered to be in respect of future services

Under a “stock appreciation rights” (SAR) plan:

- payout value at time of award is zero
- employee entitled to receive only increase in value of underlying shares
- no cash-out rights prior to vesting and, once right is vested, must be paid out by end of calendar year

Tax Positions re Stock Appreciation Rights Plan

For employee:

- amounts taken into income when SAR become vested

For employer:

- entitled to deduction at end of vesting period
- usual source withholdings apply

Individual Pension Plans (IPP)

Individual Pension Plan ("IPP")

- What is it?
- Tax Implications
- Reporting requirements
- Planning opportunities

Individual Pension Plans (IPP)

Individual Pension Plan

- “Registered” Defined Benefit Pension Plan (RPP) for Owner Manager
- Contributions determined by actuary -typically larger than RRSP amounts
- Owner manager can contribute to IPP to catch up on forgone savings for past service.
- Property within IPP creditor proof (subject to legal counsel)
- Funds are locked in until 55
- Plan sponsor is obligated to fund IPP which may be subject to pension standards legislation (like any other RPP)
- Investments Restricted - must qualify as “eligible investments”

Individual Pension Plans (IPP)

Tax implications

- Employer contributions are deductible
- If employee can contribute, then contributions are deductible in year
- Contribution limit to IPP can exceed RRSP limit
- Income within IPP is not taxable
- Amounts distributed to employees are taxable in year of receipt

Individual Pension Plans (IPP)

Individual Pension Plan

- Annual filing requirements with CRA T3P Return, T244 Information Return
- Triennial Actuarial evaluation required
- Consider Financial Statement disclosure
    i. Private company GAAP –less onerous
    ii. IFRS

Individual Pension Plans (IPP)

Planning Opportunities

- IPP in the context of a sale of the business
- IPP Succession Planning

Individual Pension Plans (IPP)

Summary

- Increased complexity, pension, legal, tax
    i. Increased Cost

But:

- Maximize retirement savings
- Potential Estate/Succession Planning opportunities

Supplementary Executive Retirement Plan

A “supplementary employee or executive retirement plan” (SERP) provides pension benefits that cannot be provided under an RPP

A defined benefit SERP typically designed to make up the difference between the pension that would be received from the underlying RPP if there were no tax limits and the pension that may be received from the RPP

A defined contribution SERP typically designed so that fixed amount with interest is added to pension to be received from the underlying RPP

A SERP is typically designed to operate outside constraints of pension standards legislation, and is not subject to investment restrictions

Tax Positions re Supplementary Executive Retirement Plan

For employee:

- amounts taken into income when received

For employer:

- amounts deductible when paid (if reasonable)

Retirement Compensation Arrangements

When SERP is funded or secured, it is a “retirement compensation arrangement” (RCA)

RCAs are subject to a discrete tax regime intended to discourage funding of SERP promise:

- 50% of amounts contributed, and realized investment earnings, must be remitted to Canada Revenue Agency (CRA)
- remitted amounts are held in non-interest bearing refundable tax account
- refundable tax is refunded when benefits are paid by the “custodian” to the employee
- In light of aggressive use of RCAs, CRA has indicated that RCAs that exceed model top-up plan may be subject to SDA rules

An RCA typically involves a trust

Retirement Compensation Arrangements

“Secured” refers to a mechanism that provides financial assurance that the promise will be fulfilled without need to maintain assets equal to present value of promise

Secured RCAs typically involve a letter of credit (LOC) issued to the custodian/trustee

Pursuant to CRA pronouncements, refundable tax is equal to LOC fee (and not LOC face value) so long as:

- LOC is unsecured
- LOC fee rather than LOC itself is contributed

Tax Positions re Retirement Compensation Arrangements

For employee:

- benefits taken into income when distributed by custodian/trustee
- contributions deductible if were required under terms of employment and total of employee contributions does not exceed total of employer contributions in year

For employer :

- contributions deductible when made

Tax Positions re Retirement Compensation Arrangements

For custodian/trustee:

- via T3 mechanism, remits 50% of realized investment earnings and receives refundable tax at rate of $1 of tax of every $2 of benefits paid
- income tax withheld on benefits paid

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