COMPENSATION PLANS

IRS Offers a Measure of – But Incomplete – Relief to Participants in Canadian Stock-based Compensation Plans

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Canadian corporations that offer stock-based or other deferred compensation plans to employees who are also United States taxpayers[1] may be creating unintended adverse U.S. tax consequences for such persons pursuant to Section 409A of the Internal Revenue Code. Code Section 409A generally provides that, unless certain requirements are met, amounts deferred under a non-qualified deferred compensation plan are to be included in the computation of gross income for U.S. tax purposes on a current basis. An employee whose deferred compensation is caught by Code Section 409A will also generally be subject to a penalty tax and interest, which amount may not be creditable in Canada. On October 4, 2005, the Internal Revenue Service (the "IRS") proposed a series of regulations under Code Section 409A (the "Section 409A Regulations") which offer long-awaited guidance on the application of Code Section 409A to non-U.S. compensation plans.

The Section 409A Regulations do not, unfortunately, offer complete relief from the application of the provision to non-U.S. compensation plans since, contrary to various submissions made to the IRS, the IRS rejected requests to the effect that any participation in a non-U.S. plan be exempted from the application of Code Section 409A or that only deferrals on U.S. source compensation be subject to the provision. In this regard, the IRS stated it was concerned that providing a broad exception for foreign plans or foreign source income would create opportunities for U.S. citizens and U.S. residents to avoid the application of Code Section 409A through reallocations of deferrals among U.S. source and foreign source income. Given the refusal to grant a blanket exemption, it will accordingly be necessary for Canadian employers to examine the potential application of Code Section 409A when structuring equity-based compensation plans where participants in the plan may be U.S. persons.

The Section 409A Regulations do provide some important guidelines for the application of Code Section 409A to non-U.S. compensation plans. In addition to specific exemptions in respect of certain non-U.S. retirement plans, certain tax equalization plans, and non-U.S. social security payments, an important exception was introduced in respect of U.S. citizens and U.S. residents working outside of the United States. By way of background, such persons are generally entitled to exclude up to US$80,000 of foreign earned income (as defined in Code Section 911) from U.S. taxation but it was unclear, prior to the Section 409A Regulations, whether such an exemption would apply for the purposes of deferred compensation plans. The Section 409A Regulations generally provide that a foreign arrangement will

not be subject to Code Section 409A where the compensation subject to the arrangement would have constituted foreign earned income paid to a qualified individual, both as defined in Code Section 911, and the amount of the compensation received under the arrangement plus other foreign earned income is less than or equal to the amount which can be excluded (i.e., US$80,000 as indexed for inflation). Thus, for example, an individual with US$70,000 of foreign earned income from regular compensation can also, pursuant to the Section 409A Regulations, defer up to US$10,000 of additional compensation under a deferred compensation arrangement if such additional compensation would qualify as foreign earned income. This exception will provide a measure of relief for U.S. persons employed in Canada but will not fully alleviate the need to evaluate the impact of Code Section 409A to U.S. persons who participate in Canadian equity-based compensation plans, particularly for those who may earn in excess of US$80,000 of foreign earned income and thus will be unable to claim an exemption in respect of any additional deferred compensation.

The application of Code Section 409A to various Canadian stock-based incentive programs will vary depending on the specific terms of such plans. In particular, the provisions of Restricted Stock Unit Plans and Deferred Stock Unit Plans may need to incorporate specific provisions in respect of participants who are U.S. persons. As discussed below, however, the Section 409A Regulations do provide important guidance with respect to stock option plans and stock appreciation rights ("SARs") plans.

Stock Options

The grant of a stock option by a corporate employer to an employee will not give rise to any immediate taxation in the employee's hands for Canadian purposes pursuant to subsection 7(1) and paragraph 7(3)(a). However, this tax advantageous treatment may be effected, in respect of U.S. taxpayers performing services in Canada, by Code Section 409A.

The Section 409A Regulations incorporate certain broad exceptions in respect of stock option plans. Most importantly, Code Section 409A does not apply to grants of stock options where the exercise price is at least equal to the fair market value ("FMV")[2] of the underlying stock at the date of grant. Most stock option plans of Canadian public corporations could be expected to meet this FMV test, both due to restrictions imposed by the stock exchange regulators and due to the desirability of allowing arm's-length employees to benefit from the paragraph 110(1)(d) 50% deduction from the employment benefit otherwise realized on the exercise of the stock option. Thus, in most cases, the applicability of Code Section 409A to such stock option plans may not be of practical import.

The Section 409A Regulations do, however, confirm that the converse is also true – Code Section 409A will generally apply in respect of stock options granted with an exercise price less than the FMV of the underlying stock on the date of grant. In this respect, it is conceivable, and perhaps even common, that stock options granted by Canadian-controlled private corporations are granted at a below market exercise price, as employees are often desirous of obtaining discounted options and claiming the paragraph 110(1)(d.1) 50% deduction from the employment benefit otherwise realized on the disposition of the shares acquired under the stock option (which deduction is generally available so long as the shares are held for at least two years). Thus, it will be necessary to evaluate the applicability of Code Section 409A to these types of plans and, if necessary, exclude U.S. persons from participation in such plans.

SARs

Code Section 409A can also potentially apply to both stand-alone SARs and to what are colloquially

known as tandem SARS (i.e., cash-out rights attached to stock options). As indicated in Notice 2005-1, which was released on December 20, 2004, the IRS initially exempted, from the application of Code Section 409A, only non-discounted SARs which were settled in stock traded on an established securities market. Such a position was adverse to many Canadian plans, which generally contemplate cash settlement.

Various criticisms were levied against the foregoing position. The discriminatory distinction between public corporations and private corporations was stated to put non-public corporations at a competitive disadvantage and the distinction between stock-settled SARs and cash-settled SARs was said to be irrelevant, particularly where the amount of income was identical in each case. In response to such criticisms, the Section 409A Regulations generally treat SARs similarly to stock options, regardless of whether the SARs are settled in cash or stock.[3] The exemption applies for both private company SARs and cash-settled SARs, provided that the amount payable on the exercise of the SAR (or cash out of the stock option) does not exceed the difference between the FMV of the underlying stock on the date of exercise and the FMV of the underlying stock on the date of grant.

Conclusion

While the Section 409A Regulations are not yet in force, the guidance they offer is welcome. Though exemptions are provided for some forms of Canadian equity-based compensation plans, the potential application of Code Section 409A will continue to be an issue worthy of examination in respect of participants in Canadian plans who are also U.S. taxpayers.

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[1] A U.S. taxpayer is anyone who is a U.S. citizen, a U.S. resident, a U.S. green card holder, or certain non-residents of the U.S. to the extent they perform services in the U.S. which are not exempt under the provisions of an applicable tax treaty.

[2] The Section 409A Regulations contain highly detailed provisions addressing permissible valuation methods, including those for publicly held companies, private companies and the valuation of illiquid stock of "start up" companies. In relying on this exception, caution in applying these rules should be exercised.

[3] To avoid perceived abuses, the Section 409A Regulations contain detailed provisions with respect to the stock that may be subject to or used to determine the amount payable under stock rights (both stock options and SARs) subject to exemption from Code Section 409A. By way of example, only common stock can be the subject to stock options or SARs.

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