EQUITY-BASED COMPENSATION

Employee Stock Purchase Trusts: an Alternative to Restricted Stock Plans

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In today's global marketplace, employers continue to seek to implement stock-based compensation plans for Canadian employees which will parallel, to the extent possible, the economic and tax consequences of restricted stock granted to employees of the United States.[1] A stock purchase trust which constitutes an employee benefit plan (an "EBP"), as defined in subsection 248(1) of the Income Tax Act,[2] may provide a partial solution.

To implement an employee stock purchase trust arrangement, the employer corporation settles a trust, the beneficiaries of which are generally the employer and the employees who will participate in the compensation plan. From time to time, the employer makes a cash contribution to the trust to be used by the trustee to acquire a specified number of shares of the employer.[3] The trustee then allocates the shares notionally for the benefit of certain of the employees and holds the shares for the benefit of those employees until the satisfaction of the vesting conditions specified under the arrangement. The trust agreement will generally provide that, prior to the satisfaction of the vesting conditions, an employee has no interest or entitlement in the shares or in any other assets of the trust. The characterization of this type of stock purchase trust will depend, in part, on whether the trustee acquires shares from the employer directly (e.g., treasury shares) or whether the shares are acquired on the open market.

Where the trustee uses employer contributions to acquire shares directly from the employer, whether from treasury or otherwise, there is a significant risk that subsection 7(2) will apply. This provision, which applies wherever a security is held by a trustee for the benefit of an employee (whether absolutely, conditionally or contingently), provides that the employee is deemed to have acquired the share at the time the trust acquired it. As a consequence, unless the employer corporation is a Canadian-controlled private corporation, the employee will be required to include the fair market value of the shares in his or her income pursuant to subsection 7(1). As a consequence, the employee will be subject to a prepayment of tax even though no benefit has actually been received because the vesting conditions have not been satisfied.[4] In addition, the employer will be denied a deduction for the amount of the contribution to the trust pursuant to paragraph 7(3)(*b*).

Consequently, employee stock purchase trusts should generally be structured so that the trustee is prohibited from using employer contributions to acquire shares directly from the employer corporation or from a related corporation.

Where, however, the trustee uses employer contributions to acquire shares on the open market, the arrangement will generally constitute an EBP since it will be an arrangement under which an employer makes contributions to a third party for the benefit of employees. In order to ensure that the employee is

not subject to immediate tax, it is crucial that the vesting conditions be such that the arrangement not constitute a salary deferral arrangement ("SDA"). The exception which is generally relied upon is that contained in paragraph (*k*) of the SDA definition in subsection 248(1). This exception applies where the employee has the right to receive the payment by December 31st of the third year following the year in which it was earned. Thus, the arrangement will generally provide for a three-year vesting period, or such shorter period as is comparable to the vesting period under the comparable restricted stock plan.

So long as the arrangement does not constitute an SDA, paragraph 6(1)(*a*) will ensure that the employee is not subject to tax at the time the employer makes the contribution to the trust or at any time until the vesting conditions are satisfied.[5] At the end of the vesting period, the shares are distributed to the employees at which time the employee will be, pursuant to subparagraph 6(1)(*g*)(ii), subject to tax, at employment income rates, on the fair market value of the shares. The employee will be deemed to have acquired such shares at a cost equal to the fair market value of the shares at that time pursuant to subparagraph 107.1(*b*)(ii).

In implementing this sort of arrangement, it must be kept in mind that the trust will be a "taxpayer" and will, accordingly, be subject to tax on all income earned in the trust, including dividends paid on the shares held by the trust, unless the income is allocated and paid to a beneficiary of the trust in the year in which it is earned pursuant to paragraph 104(6)(*a*.1) and subsection 122(1). Thereafter, the amounts that are distributed to the employee participants will also be subject to tax in the employees' hands pursuant to subparagraph 6(1)(*g*)(ii). To avoid this potential "double-tax," arrangements of this type should be structured so that the trustee is required to allocate all income earned by the trust to a beneficiary in the year in which it is earned. The income could be allocated and paid to employees as income beneficiaries of the trust, in which case, the employee gets the benefits of distribution. In this situation, the employee will be subject to tax on the full amount of the income, at regular employment income rates, notwithstanding the original source of the income as dividends. In other words, the character of the amount of the dividend will not carry through in the hands of the recipient employee. Alternatively, the amounts of income could be distributed to the employer as income beneficiary of the trust[6] and the employer could then, if desirable, use the funds to declare and pay a bonus to the employees. In this circumstance, the bonus should be deductible and should offset the income inclusion realized by the employer on the receipt of the distribution from the trust.

From the employer's perspective, paragraph 18(1)(*o*), subsection 18(10) and section 32.1 will operate so as to delay the employer's deduction for its contributions to the trust until the time the amounts are distributed to employees or the plan is wound-up. It is these provisions which give rise to a significant disadvantage of the EBP arrangement – while the employer has the immediate funding cost for contributions to the trust, the deduction will be delayed. The deduction under section 32.1 is the lesser of the amount by which the total amounts distributed to employees in the year exceeds the income of the trust and the aggregate amount of previously undeducted contributions. This "lesser of" formula gives rise to a potential mismatch between the employer contribution, the employer deduction and the employee income inclusion. This can be illustrated by an example. Assume that, in 2006, an employer contributes $100 to the trust for the purposes of acquiring 10 of its shares on the open market at a price of $10 a share. In 2008, the shares vest and are distributed to the employee beneficiaries at a time when the price of the employer's shares increases to $15. Consequently, the employee would have an income inclusion of $150 under paragraph 6(1)(*g*) but the employer would be entitled to a deduction of only $100 under paragraph 32.1(1)(*a*). In contrast, if the shares decrease in value from the time of the acquisition by the trust and the distribution to an employee, the employer will only be able to deduct an amount equal to the fair market value of the shares at the time of their distribution. The effects of this mismatch should be kept in mind in making the decision to implement a stock purchase trust of this type.

While an employee stock purchase trust will not fully parallel the tax consequences to a Canadian employee that a restricted stock plan will provide to a U.S. employee, it is an arrangement worth considering where it is desirable to provide similar compensation schemes to employees on both sides of the border.

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[1] By way of background, restricted stock plans generally involve the grant of employer stock to an employee but the stock is subject to forfeiture if certain conditions are not met or if the employment relationship is terminated before the vesting conditions are satisfied. Unlike the tax treatment of restricted stock under the Internal Revenue Code (United States), which generally defers taxation until the vesting conditions are satisfied, a grant of restricted stock by a corporation (other than a Canadian-controlled private corporation) to a Canadian employee will cause the employee to have an immediate income inclusion pursuant to subsection 7(1), with potentially no offset should the restricted stock be subsequently forfeited. For this reason, restricted stock is generally not a viable employee compensation scheme in Canada.

[2] R.S.C. 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the "Act." Unless otherwise stated, statutory references in this article are to the Act.

[3] The arrangement can also be structured so that the employees make a contribution to the trust through payroll deductions, which contributions vest immediately, and the employer makes a matching contribution which is then subject to the vesting conditions.

[4] If the employee later forfeits his or her entitlement, subsection 8(12) may permit an offsetting deduction but, even in that event, the employee will have prepaid the tax liability.

[5] The Canada Revenue Agency ("CRA") has given several positive rulings on the interaction of the SDA rules and EBP arrangements in, for example, CRA Rulings 2004-0068151R3 (2004), 2003-004714R3 (2004), 2003-0053041R3 (2004), and 9618943 (1996).

[6] Where the amount of a capital gain recognized by the trust is being distributed, care should be taken to ensure that the trust does not make any designations under subsection 104(21). Where such a designation is made, double taxation may result – once as a capital gain due to the designation and then again as income pursuant to paragraph 12(1)(*n*.1). The CRA has confirmed, in CRA *Document* 9909175 (July 8, 1999), that this was the intended result of the provisions and consequently, the EBP trust should avoid making any designations pursuant to subsection 104(21). See also CRA *Document* 2004-0075211R3 (2004).

Published in *Taxation of Executive Compensation and Retirement*, (2005) vol. XVII, number 4, page 614

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