Pensions and Employee Compensation Group

Employee Incentive Programs

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Employee Incentive Programs: Taking Stock of Your Options

Despite the recent setback in equity markets, stock-based employee incentive programs have remained a key tool for domestic and multinational employers in compensating, rewarding and retaining a qualified workforce and aligning the interests of management and employees alike with the ongoing and ultimate corporate objective of creating shareholder value. The Pensions and Employee Compensation Group at McMillan Binch, one of Canada's leading business law firms, possesses industry-leading expertise and experience in developing, customizing and implementing such stock-based compensation programs on behalf of domestic and foreign employers.

In particular, McMillan Binch offers the following services:

(1) drafting and developing a flexible and tax-efficient stock-based compensation plan in consultation with an organization's legal and human resources representatives;

(2) tailoring international stock compensation plans to meet Canadian legal requirements (lender securities and privacy laws) and improving the tax results of the plan for both Canadian participants and their employers;

(3) securing exemptions, where required, from the prospectus and registration requirements of Canada's various provincial securities laws;

(4) creating or customizing employee disclosure and informational documents in connection with the plan and arranging for French translation where required (or desirable);

(5) advising on and structuring employee payroll financing programs with respect to a plan and the withholding tax obligations in relation thereto; and

(6) ensuring all ongoing reporting and other compliance requirements with respect to the plan are satisfied and continuously monitoring and evaluating the efficiency of the plan in light of legislative and other developments.

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The following presents an overview of some of the major Canadian securities and tax legal requirements relevant to a typical stock-based compensation plan.

Canadian Securities Considerations

Jurisdiction over securities law in Canada rests with the various provincial governments, rather than the federal government. In the case of employee offerings, an employee's province of residence determines which provincial securities legislation applies. This means that a company planning to offer securities to employees must comply with the securities legislation of every province in which its employees reside. That is the bad news; the good news is that the relevant securities laws of most provinces, except Québec, are relatively consistent. Consequently, to ensure compliance with provincial securities requirements, employers must first identify all provinces in which their employees reside.

Statutory Exemptions

A company offering securities to its Canadian employees may generally avail itself of the statutory exemptions from the requirement to file a prospectus that are available under most provincial securities legislation. Similarly, there are also statutory exemptions available in many provinces that eliminate the need for the issuing company to be a "registered securities dealer", or for the securities to be offered through a securities dealer registered in the province.[1] Canadian provincial securities laws do not restrict the number of employees who may participate in an exempt distribution of securities. However, to qualify for the statutory exemptions, the issuing company must meet certain criteria relating to its shareholdings and number of shareholders residing in Canada.

For most provinces, these statutory exemptions will automatically apply. An exception is the province of Québec, which requires an issuer to file and distribute to its Québec-resident employees a document known as an "offering notice". This short document, prepared in French (or French and English, if preferred), provides general information about the offering and the securities to be issued and must be signed by a representative of the issuer. The issuer's most recent financial statements must be attached to the notice or otherwise made available to the affected employees, including by way of the company intranet.

In certain circumstances, issuers may apply for a waiver from the requirement to file and deliver an offering notice. The Québec securities regulator will generally grant such waivers to issuers with fewer than 50 employees residing in Québec, provided that the issuers provide their employees with some form of substantially equivalent disclosure, such as a US or international prospectus.

No other province imposes disclosure requirements on issuers relying on statutory exemptions for their employee offerings.

Exemption Orders

Companies issuing securities to employees of affiliated companies, former employees or employees in an "employment-like" relationship with the company (for instance, independent contractors, arm's-length service providers or franchisees) may not qualify for the statutory exemptions described above. In addition, the statutory exemptions may not be available to non-corporate issuers such as partnerships or trusts and do not generally apply in situations where the shares or other securities allocated to employees are held through independently-managed special purpose holding vehicles (as is often the case for plans originating in France). In these cases, the company must instead obtain a discretionary exemption order from the relevant provincial securities regulators.

Where discretionary exemption orders are required in more than one province, an issuer will typically file one application with the securities regulator in the province in which the issuer's head office is located or, if the head office is outside of Canada, where the majority of employees eligible to participate in the particular offering reside. This regulator, known as the "principal regulator", takes on the task of co-ordinating the processing of the application with the other "non-principal" provincial regulators. The application is typically in the form of a letter requesting the exemptions This letter generally sets out the basis for the request, the details of the offering, the text of the requested order(s), and a verification statement from the issuer confirming the accuracy of the information provided. The filing fees associated with such applications range from Cdn$500 to Cdn$2,000 (per province), depending on the provinces involved and the extent of the exemptive relief required.

Regulatory authorities generally take between six and eight weeks to process an application and issue an exemption order.

Disclosure Requirements

As noted above, aside from Québec, issuers are generally not required to provide employees with specific disclosure relating to the particular offering. Nevertheless, in practice, issuers typically do provide employees with an information package describing the offering's basic terms, what employees must do to participate, and any applicable Canadian laws restricting the resale of the shares. Often, companies also provide a summary of the domestic and foreign tax consequences for employees participating in the offering.

Where a discretionary exemption order is required for an employee share plan being offered concurrently with a public offering, a typical condition for the receipt of the requested exemption orders is the requirement that the participating employees receive of a copy of the US or international prospectus (for informational purposes) prior to making their investment decision. Companies relying on the statutory exemptions may nevertheless wish to provide this information voluntarily, to ensure that employees in all jurisdictions are on a level footing with respect to disclosure regarding the investment.

Resale Restrictions

Provincial securities laws generally restrict the resale of shares acquired under an employee offering. If a company making a prospectus-exempt offering to Canadian employees is not a "reporting issuer" in Canada,[2] the shares acquired in the offering may not be transferred or sold in Canada, whether between Canadian employees or otherwise.

Most of the provinces, however, do allow Canadian employee-owned shares to be sold over a foreign stock exchange or to a person or company outside of Canada.

Reporting Requirements

Regardless of whether the statutory or discretionary exemptions described above apply, some provincial securities regulators require issuers to file reports, at least annually, on the issuance of securities or grant and exercise of options. Such reports are filed with each applicable provincial regulator. A nominal fee for each filing will normally apply.

Canadian Income Tax Considerations

Taxable Benefits from Employment

In general, the grant to an employee of an option or right to purchase shares of his or her employer (or those of an affiliate) produces no immediate tax liability to the employee. Taxes, in the form of an employment benefit (the "Employment Benefit"), may arise, however, on the exercise or other disposition by the employee of the option or right unless certain conditions are satisfied, in which case the Employment Benefit, if any, is deferred until the ultimate disposition of the shares. The quantum of the Employment Benefit to be included in income, in circumstances where an employee exercises a right to acquire shares, will generally be equal to the fair market value of the shares at the date of their acquisition by the employee, less any amounts paid by the employee to acquire the shares (including any amounts paid for the option or right). A deduction equal to 50% of the Employment Benefit may be available if certain conditions are satisfied, including the length of time the shares are held (in the case of shares in a "Canadian-controlled private corporation" (CCPC)) or where the option or right was not "in the money" at the date of its issuance.

Employment Benefits are generally added to an employee's remuneration for Canadian social security purposes (*i.e.*, employer and employee contributions under the Canada Pension Plan).

Dividends

Dividends received by participating employees on their shares must be included in their income for that year. Canadian source dividends (*i.e.*, where the dividend paying corporation is a "taxable Canadian corporation") may receive favourable tax treatment by virtue of the "gross-up" and dividend tax credit mechanism available under Canadian tax law. Foreign source dividends will not receive this favourable tax treatment and, in addition, may be subject to withholding tax in the jurisdiction where the dividend paying corporation resides. Participating employees, however, may be eligible to claim any such withholding tax as a foreign tax credit when computing their Canadian income tax liabilities.

Capital Gains and Losses

An employee's sale or other disposition of shares acquired under an employer stock option or purchase plan will generally result in a capital gain or loss to the employee equal to the difference between the proceeds realized on the sale and the employee's "adjusted cost base" of the shares, plus all reasonable costs associated with the disposition. In most cases, the average cost of all of the employee's shareholdings will constitute the adjusted cost base of any individual share sold. To prevent double taxation, the employee's adjusted cost base is deemed to include any Employment Benefit amounts discussed above.

Subject to certain exemptions involving CCPC shares, one-half of any capital gain generated by a sale of shares is included in the employee's income as a taxable capital gain. Similarly, the employee may apply one-half of any capital loss that is realized against taxable capital gains from other sources, in accordance with Canadian tax rules.

Tax Tips

- For Canadian tax purposes, all sums of money in a foreign currency relating to the acquisition, holding and disposition of options or shares must be converted into Canadian dollar equivalents.
- Canadian tax law sets no minimum time period for which shares acquired under an employer stock purchase plan must be held. However, if shares are offered to employees at a price which is less than their

publicly-traded value, holding periods on the shares (*i.e.*, restrictions on resale) may be necessary to avoid or at least minimize the up front taxable benefit.

- Canadian tax law does not restrict the amount of shares or options that may be acquired through employee incentive programs.
- To access optimal tax treatment, employee stock options should not be granted with an exercise price which is less than the fair market value of the shares on the grant date.
- Canadian tax law does not recognize a concept similar to the U.S. distinction between "qualified" and "non-qualified" stock option plans.
- Stock purchase and option programs will generally carry with them reporting obligations on the part of the employer (or in certain circumstances, other members of the employer's corporate group); these rules should be identified up front and procedures put in place to ensure compliance.

Conclusion

A carefully crafted stock incentive program can contribute in a meaningful way to the long-term success of an enterprise. Part of the process inevitably involves an understanding of the applicable securities and tax regimes, along with any other regulatory and legal requirements which must be satisfied.

The foregoing provides only an overview of some of the Canadian legal considerations applicable in connection with the offering of securities to employees. Readers are cautioned against making any decisions based solely on this material.

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