# Taxation of Equity-Based Executive Compensation in Canadian Technology Start-Ups

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# Table of Contents

I. The Backdrop:  Changing Approaches to Executive Compensation ....................................................................2

II. The ITA's General Framework Governing Taxation of Equity-Based Compensation........................................4

III. Comparing the Tax Treatment of Stock Options and Restricted Shares ..........................................................13

Conclusion ..........................................................................................................................................................16

Bibliography.........................................................................................................................................................18

This paper compares the tax implications of two common approaches to equity-based compensation of executives in technology start-ups in Canada: stock options and restricted shares. It does so in the shadow of two not unrelated events that have had significant impact on the design of executive compensation packages in recent years. First, the 2008-2009 financial crisis has brought much-increased scrutiny of executive compensation practices worldwide. Second, the 2010 federal budget introduced significant changes to Canada's taxation of stock options as part of its mixed package of stimulus and austerity measures in response to the crisis.[1] Although the favourable treatment of stock options and restricted shares of Canadian-controlled private corporations ("CCPCs"), which are the focus of this study, was mostly unaffected, the elimination of certain benefits associated with shares of non-CCPCs in that budget have had the effect of making CCPC securities even more relatively attractive compared to those of public and non-resident corporations.

In designing longer term executive compensation strategies, technology start-ups share a number of common motivations with going concerns, including the need to attract and retain talented leadership, to align the interests of executive management with those of shareholders, and generally to motivate performance - all in a manner that is tax efficient from the standpoint of both executives and the corporation, as well as acceptable to shareholders. But the need to conserve cash in a start-up environment normally excludes the adoption of schemes such as phantom stock plans and others based on appreciation of the corporation's underlying share value, yet ultimately settled in cash. Further, given the normal focus on an exit strategy by way of acquisition or IPO, it is important that the selected approach be readily understood by potential acquirers as well. Since stock options and restricted shares largely meet both of these requirements, I focus on these two approaches accordingly.

Although the focus of this paper is on an analysis of existing tax rules, it will be useful to first ground the discussion in its broader context. I therefore begin with an overview of recent changes in approaches to executive compensation and consider their relevance in the context of technology start-ups. In the second section I review the Income Tax Act's[2] general framework governing taxation of equity-based compensation, with specific application to stock options and

[1] The Department of Finance has estimated that for 2011 - *following* the 2010 budget measures - tax expenditures (forgone tax revenue) associated with employee stock option deductions and lifetime capital gains exemption for small business shares (discussed further in this paper) together still amount to over $1.25 billion annually, among the larger such policy expenditures: Canada, Department of Finance, "Tax Expenditures and Evaluation 2011" (2012).
[2] R.S.C. 1985, c. 1 (5th Supp.), as amended (herein referred to as the "ITA").

restricted shares. In section three I compare the differing tax consequences associated with stock options and restricted shares, concluding that in many situations restricted shares can be a significantly better choice than stock options for Canadian technology start-ups and their executive teams.[3]

## I. The Backdrop: Changing Approaches to Executive Compensation

The 2008-2009 financial crisis and the Occupy movement greatly increased the scrutiny to which executive compensation had already been subject in previous years. In 2005, for instance, the Canadian Coalition for Good Governance issued its "Good Governance Guidelines for Principled Executive Compensation", emphasizing the need for executives to hold substantial equity positions in companies they lead, strong links between pay and performance, the development of independent compensation committees, and the necessity of disclosure.[4] Building on such principles after the financial crisis, global stakeholders such as the Financial Stability Board ("FSB") have also highlighted the importance of aligning compensation with the nature of risk undertaken and adjusting payout schedules to the time horizons of such risk.[5] The consequences of these developments are only beginning to be felt, particularly in respect to compensation requirements of security exchanges.[6] Other trends already discernible include significant reductions in the use of stock options - especially in Canada due to concerns regarding dilution and tax changes introduced in the 2010 budget - and the development of portfolio approaches to executive compensation that combine various cash and equity schemes with differing characteristics and timelines.[7]

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[3] Due to space restrictions I omit a discussion of taxation issues that arise in the context of merger and acquisition transactions, which are important but complex. For a detailed discussion, see Anne Montgomery and Lawrence Levin, "Corporate Transactions: Cross-Border Compensation Restructuring" in "Corporate Tax Planning," (2011), vol. 59, no. 3 *Canadian Tax Journal*, 645-671.

[4] "2009 Executive Compensation Principles" (Toronto: Canadian Coalition for Good Governance, 2009), at 3 (http://www.ccgg.ca/site/ccgg/assets/pdf/2009_Executive_Compensation_Principles.pdf).

[5] "FSF Principles for Sound Compensation Practices" (Basel: Financial Stability Board, 2009), at 2-3 ( http://www.financialstabilityboard.org/publications/r_0904b.pdf).

[6] See, for example, the Toronto Stock Exchange's "Guide to Security Based Compensation Arrangements" ( http://www.tmx.com/en/pdf/SBCA_guide.pdf), "Canadian Securities Administrators' Staff Notice 51-331: Report on Staff's Review of Executive Compensation Disclosure", published November 20, 2009 by the B.C. Securities Commission (http://www.bcsc.bc.ca/uploadedFiles/securitieslaw/policy5/51-331_CSA_Staff_Notice.pdf), and the Security Exchange Commission's Proposed Rule regarding "Incentive-based Compensation Arrangements" (http://www.sec.gov/rules/proposed/2011/34-64140.pdf).

[7] Christopher Chen and Anand Parsan, "Trends in Executive Compensation: A Closer Look at the Details" (October 26, 2011), presentation for Conference Board of Canada (http://www.conferenceboard.ca/e-library/abstract.aspx?did=4448), at 14-15.

As key participants in the global discussion, it is not surprising that Julie Dickson, head of Canada's Office of the Superintendent of Financial Institutions and member of the FSB compensation group, Mark Carney, governor of the Bank of Canada and chair of the FSB, and Jim Flaherty, Canada's Finance Minister, have all lent their voices in support of such principles.[8] Nevertheless, as Gloria Geddes has observed, "Canada's income tax laws have not kept pace with the evolution in compensation governance, and in some circumstances they penalize rather than motivate compliance",[9] as I note further in due course.[10] One might also question the relevance of guidelines developed mostly for public corporations - particularly in response to perceived abuses in the financial sector - for compensation practices among technology start-ups, where shares are typically closely held and founders and second-stage investors are prone to maintain a very hands-on approach to corporate governance and strategy. Still, it seems likely that over time such broader developments, to some degree at least, will begin to be reflected in compensation strategies in private company contexts, even in the technology sector, perhaps mediated initially through more sophisticated portfolio investors such as venture capital corporations.

In this connection, it should be recognized that both stock options and restricted shares can be issued in a manner that is more attuned to current best practices than mere time-based vesting conditions incenting retention only. First, both stock options and restricted share plans can incorporate performance conditions, whether standalone or in conjunction with time-based conditions, and the ITA neither penalizes nor favours linking equity-based compensation to performance in this manner. Making equity awards conditional on results is becoming more common,[11] even apart from its intrinsic merits, partially as a consequence of exchange requirements related to the disclosure of targets that form the basis of executive compensation.[12] A second opportunity to incorporate current best practices into executive compensation schemes lies in issuing restricted shares as an alternative to stock options. Most obviously, ownership of restricted shares fulfills the requirement that executives hold equity positions in companies they

[8] See Gloria Geddes, "Executive Pay Packages: Compensation Planning in Light of Increased Scrutiny" (2009), at 4-5 (available at www. gowlings.com).
[9] Geddes, supra note 8, at 2.
[10] I refer specifically to the availability of the paragraph 110(d) deduction only for shares acquired at FMV or higher.
[11] Geddes, supra note 8, at 12.
[12] See "Trends in Executive Compensation", supra note 7, for a summary of such requirements for various exchanges internationally.

lead in a manner that holding stock options does not. But granting restricted shares also addresses the principle concerning the need to align compensation with risk in that they provide an incentive for executives to consider the downside risks of decisions that may decrease the value of their shareholding. In contrast, traditional stock options granted at the money offer only upside potential and therefore are generally viewed as incenting greater risk-taking.[13] Certainly, some would consider such points as rather too nuanced in a start-up environment, where upside tends to be the overwhelming focus of all stakeholders given that most technology start-ups "go big or go bust." But in fact many such firms end up somewhere between these extremes, so diminished value is a genuine concern. All other factors being the same, it is difficult to argue with the conclusion that restricted shares are significantly more powerful in inducing shareholder-like mentality and behaviour, particularly when they are not stripped of voting rights.[14] However, in reality all other factors are *not* the same in this regard - here, in contrast to the linking of pay to performance, rather than being neutral, Canada's tax system actually favours the award of restricted shares over stock options in some circumstances, for reasons explored more fully in section three.

## II. The ITA's General Framework Governing Taxation of Equity-Based Compensation

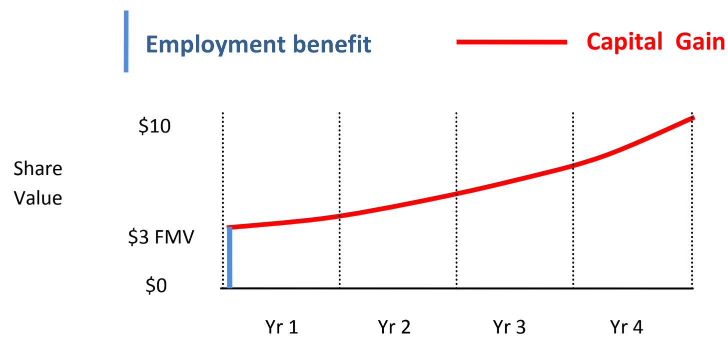
Most equity-based executive compensation schemes are captured by the broad wording of section 7 of the ITA, which is applicable where a corporation has "agreed to sell or issue" shares of its capital stock (or shares of a related corporation) to its employees (or employees of a related corporation).[15] The Canada Revenue Agency ("CRA") has observed that "'issue' means to deliver unissued shares of a corporation, including to deliver unissued shares for no monetary consideration."[16] Thus, stock option plans and agreements to issue restricted shares have both been recognized as falling under section 7.[17] However, subsection 7(5) indicates that section 7 is not applicable "if the benefit conferred by the agreement was not received in respect of, in the course of, or by virtue of, the employment". Thus, shares issued to employees in their capacity

[13] Geddes, supra note 8, at 9.
[14] Dividend and liquidation rights are typically of less significance in a start-up environment.
[15] Subsection 7(1).
[16] *Interpretation Bulletin* IT-113R4, "Benefits to Employees - Stock Options", August 7, 1996, at paragraph 6.
[17] For stock options, ibid., at paragraph 6; for restricted shares, see for example, "Employees' Taxation under Stock Option Plan" (1990), *Window on Canadian Tax Commentary*, Document number: AC59264 (North York, ON: CCH Canadian).

as shareholders may be excluded from the application of section 7,[18] as would shares of the corporation purchased by an employee directly from a fellow employee or shareholder.[19] In spite of the restriction of section 7 to shares acquired as a result of employment, its provisions continue to apply even when such employment has ended after the agreement to sell or issue shares was made.[20] This clarification may hold significant favourable tax implications for executives who, at the time employment is terminated, hold substantial options already vested and still capable of being exercised, or shares whose restrictions have expired.

When section 7 is applicable to an agreement to sell or issue shares, any *initial* economic benefit derived by the employee at the time the shares are acquired will be characterized as an employment benefit subject to taxation at the applicable marginal rates, while *subsequent* economic benefit or loss will be treated as a capital gain or loss. In simplest terms, the ITA's approach toward characterization might be diagrammed as follows:

**Figure 1: Economic Benefit from Shares Derived from Employment**




Here, on commencement of employment, the employee is given (at no cost) a single share valued at three dollars, which is sold four years later when it is worth ten dollars. The initial economic benefit is characterized as an employment benefit in the amount of three dollars, while the subsequent increase in value of seven dollars is characterized as a capital gain. The following sections address the details of these characterization schemes with application to stock options and restricted shares.

[18] IT-113R4, supra note 16, at paragraph 4. For further discussion of this issue, see CCH Commentary on ITA s. 7 "Benefit not received 'in respect of, in the course of, or by virtue of, the employment'", at paragraph 2759.
[19] IT-113R4, supra note 16, at paragraph 4. The bulletin is actually silent regarding the reason for this particular exclusion, which could instead be due to the fact that the shares are not sold or issued by the corporation in such circumstances, as required by s. 7(1).
[20] Subsection 7(4).

## A. Employment Benefit

The mere existence of an agreement to sell or issue shares to an employee does not in itself create a tax liability.[21] Normally, tax consequences are triggered only when the employee actually *acquires* the shares.[22] In the case of stock options, acquisition usually occurs when at some point after the vesting conditions have been met the employee exercises an option and purchases shares. Restricted shares, in contrast, are considered to be acquired when issued by the corporation to the employee, even though they still may be subject to vesting conditions.[23] More generally, the CRA considers acquisition to occur when legal ownership of the shares has been transferred.[24] Tax liability may also be triggered in certain other circumstances even where the employee has not acquired the shares under a stock option plan, such as when the employee dies prior to exercising the option or transfers or disposes of rights under the plan to arm's length or non-arm's length parties.[25] Among the more common scenarios caught by the latter provisions are employer buy-outs of an employee's options.[26]

When the employee thus acquires the shares, or is considered to have disposed of the right to acquire them, he or she is generally deemed to have received an employment benefit in that taxation year.[27] In the case of disposition of the right to acquire the shares, the benefit is calculated by deducting the amount paid by the employee for the right to acquire the shares (such

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[21] Subsection 7(3) and *Steen v. The Queen*, 88 DTC 6171 (F.C.A.), aff'g 86 DTC 6498 (F.C.T.D.).
[22] Subsection 7(1).
[23] See IT-113R4, supra note 16, at paragraph 9, and *Window on Canadian Tax Commentary*, Document number: AC59264, supra note 17.
[24] "Tax Treatment of Employee Stock Options" (June 7, 2007), *Window on Canadian Tax Commentary*, Document number: 2006-0217731E5 (North York, ON: CCH Canadian). In some circumstances, such as when title remains with the vendor as security for the unpaid balance, timing of acquisition will be considered to have occurred "when all incidents of title (such as possession, use, and risk) pass": IT-113R4, supra note 16, at paragraph 10. Other issues arise when shares are paid for over time: ibid., at paragraph 10.
[25] Paragraphs 7(1)(b)-(e).
[26] IT-113R4, supra note 16, at paragraph 11, applies in respect to paragraph 7(1)(b), provided the employee has the right to choose cash instead of shares. Note that employees are normally considered to deal with their employers at arm's length, as specified in paragraph 7(1)(b). Subsection 7(1.7) also provides that where an employee's right to acquire shares ceases to be exercisable, even if the cessation would not be considered a transfer or disposition of rights as described in paragraphs 7(1)(b)-(e), it is nevertheless deemed to be a disposition triggering tax liability. The provision was added following the decision in *Buccini v. The Queen*, 2000 DTC 6685, in which the Federal Court of Appeal held that a release payment made to an employee as consideration for release of options upon a corporate amalgamation should be characterized as the employee's *repudiation* of his rights rather than *disposition* and was thus not taxable. Again, further discussion of option buy-outs, which often occur in the context of a merger or acquisition, are beyond the scope of this paper.
[27] Paragraphs 7(1)(a)-(e).

payments are seldom required in practice) from the amount received for disposing of that right.[28] In the case of acquisition of the shares, the benefit is calculated by deducting the amount paid by the employee for the shares (plus any amount paid for the right to acquire the shares - again, likely nothing) from their "value" at the time they were acquired.[29]

The CRA considers the "value" of shares in the context of section 7 to refer to their fair market value ("FMV"),[30] here as elsewhere understood to be "the highest price, expressed in terms of money or money's worth, obtainable in an open and unrestricted market between knowledgeable, informed and prudent parties acting at arm's length, neither party being under any compulsion to transact."[31] For publicly traded shares, FMV is evident, whereas for privately traded shares also subject to restrictions, determining FMV is significantly more difficult. Both their private character and the nature of the specific restrictions need to be accounted for in assessing a suitable discount. The CRA has commented that the value of restricted shares is "the fair market value of identical shares at the time of acquisition that have no trading restriction less an appropriate discount in respect to the restriction."[32] Presumably the same approach would be applicable in respect to other vesting conditions aside from trading restrictions, such as those based on performance. Although no further guidance is available to date, the CRA has indicated that valuators working under of the auspices of its Business Equity Valuation Program, responsible for determining the value of private and public securities, adhere to standards developed by the Canadian Institute of Chartered Business Valuators.[33] In a technology start-up context, although the most recent price paid by investors may provide a suitable starting point for determining the underlying share value, estimating the discount associated with any restrictions will still necessarily involve a degree of judgment and will be subject to potential risk of reassessment.[34]

[28] Paragraphs 7(1)(b), (b.1), (d), and (d.1). The wording of these provisions (which generally refer to "rights under the agreement") is not restricted to the right *to acquire* the shares, but this is the most common right initially in view on transfer or disposition.
[29] Paragraph 7(1)(a).
[30] IT-113R4, supra note 16, at paragraph 1.
[31] *Information Circular* 89-3, "Policy Statement on Business Equity Valuations", August 25, 1989, at paragraph 3.
[32] "Stock Option FMV and Trading Restriction" (2002), *Window on Canadian Tax Commentary*, Document number: 2002-0171137 (North York, ON: CCH Canadian).
[33] *Information Circular* 01-1, "Third Party Civil Penalties", September 18, 2001, at paragraph 46.
[34] One commentator with long experience in the venture capital sector in British Columbia has indicated he has never heard of the CRA challenging a taxpayer's estimate of the discount associated with the value of share restrictions: See Mike Volker, "Shares vs Stock Options", May 30, 2011 (http://mikevolker.com/shares-vs-stock-options/). For further information regarding share valuation, see Richard Wise, "Valuation: Recent Developments"

### *Deferral of the Employment Benefit and CCPC Status*

As already indicated, the employment benefit thus determined generally will be taxable within the current taxation year.[35] This rule can create serious cash-flow challenges in situations where the employee does not immediately dispose of the acquired shares, which is usually difficult when the shares are not publicly traded. Partially in recognition of this difficulty, for shares of CCPCs the income inclusion is deferred until the year in which the employee disposes of, or exchanges, the shares.[36] Importantly, the deferral is available for the employee even if the corporation ceases to be a CCPC at some point after the agreement governing the acquisition of the shares was made.[37] Until 2010, the deferral had also been available in certain other circumstances for non-CCPC shares, [38] but was eliminated in the 2010 federal budget, with transitional rules for shares acquired but not sold before the effective date of the changes.[39]

The deferral of the employment benefit is one of three key advantages associated with the taxation of employees' shares of a CCPC. The others, concerning deductions from both the employment benefit and capital gains, will be discussed below. There are also other benefits associated with the taxation of CCPCs aside from the treatment of income derived from shares by employees, including a lower rate of corporate tax on the first $500,000 of income[40] and refundable tax credits for qualifying research and development expenditures.[41] Together, such

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(2006) Canadian Tax Foundation, Conference Report (www.ctf.ca) and "Valuation Issues Relating to Shares of Private Corporations" (2004) Canadian Tax Foundation, Conference Report (www.ctf.ca).

[35] Acquisition of the shares will also trigger an obligation on the part of the employer to withhold and remit an amount equal to the employment benefit, less the paragraph 110(1)(d) or 110(1)(d.1) deduction (discussed below), even though the employee has received no cash as a result of the acquisition: paragraph 153(1.01). Since 2010, the CRA is no longer permitted discretion to lessen the withheld amount on the basis of hardship: subsections 153(1.1), (1.31). Note, however, that shares of CCPCs are exempted from the withholding requirement at time of acquisition if the paragraph 7(1.1) deferral is in effect: paragraph 153(1.01)(b).

[36] Subsection 7(1.1).

[37] This derives from the wording of subsection 7(1.1), which only requires the corporation to be a CCPC at the time of the agreement to sell or issue shares to the employee.

[38] The main provisions were subsections 7(8)-(15), repealed as a result of the 2010 budget by S.C. 2010, c. 25, ss. 3(8),(10).

[39] Section 180.01.

[40] Sections 123-25.

[41] Section 37. Although the core Scientific Research and Experimental Development ("SRED") program remains in place, the recently released 2012 federal budget announced a number of changes designed to increase its effectiveness: Canada, "Jobs, Growth and Long-term Prosperity: Economic Action Plan 2012" (Ottawa: Department of Finance, 2012), at 68f.

factors can provide compelling reasons for the attainment and preservation of a corporation's status as a CCPC from the standpoint of both investors and employee-shareholders.[42]

Most Canadian start-ups are able to meet the requirements for CCPC status, which generally means that the corporation must have been incorporated in Canada, is not publicly traded, and is not controlled by combinations of non-residents or public corporations.[43] The reference to public corporations in the CCPC definition excludes - thus making an exception for - "prescribed venture capital corporations", which refers to tax-advantaged venture capital investment vehicles established under provincial legislation.[44] Some funds established under the venture capital corporation framework are publicly traded, so the fact that Canadian corporations controlled by publicly traded venture capital corporations can still qualify as CCPCs reflects significant policy support for venture capital investment in Canada and broadens the application of the favourable tax treatment of employee-owned shares of CCPCs.[45]

The concept of control for purposes of the CCPC definition is extremely broad, encompassing both legal and effective control.[46] Legal control refers to the ownership of a majority of voting shares enabling an investor or group of investors to elect the board of directors.[47] It extends to indirect control through use of intermediary corporations[48] and is also determined by considering any rights to obtain shares entitling one to control as if those rights were fully exercised.[49] So, for example, convertible preferred shares - the most common form of venture capital equity - will be treated as if converted to common voting shares. Therefore, no more than 50 percent of a CCPC's voting shares may be owned, whether in fact or by unexercised right, by combinations of non-residents or public corporations. The concept of

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[42] For further discussion of the broader benefits of CCPC status in connection with technology companies, see Scott Ollivierre, "The Influence of Taxation on Capital Structure in Venture Capital Investments in Canada and the United States" (2010) 68 *U. Toronto Fac. L. Rev.* 9, at 27f.

[43] Subsection 127(5), "Canadian-controlled private corporation", subsection 89(1), "Canadian corporation", "private corporation", "public corporation"

[44] ITA Regulation 6700. In British Columbia, the applicable statute is the Small Business Venture Capital Act, S.B.C. 1985, c. 56. For an overview of the associated tax benefits in British Columbia, see the Ministry of Small Business, Technology and Economic Development web site (http://www.tted.gov.bc.ca/tri/ICP/VCP/VCC/Pages).

[45] See, for example, Pender Growth Fund (VCC) Inc. ("PTF"), which is registered as a British Columbia venture capital corporation and trades on the TSX Venture Exchange.

[46] See the discussion of *de jure* (legal) and *de facto* (effective) control in *Interpretation Bulletin* IT-64R4, "Corporations: Association and Control", last revised October 13, 2004, at paragraphs 13-23.

[47] *Buckerfield's Ltd. v. Minister of National Revenue* (1964), 64 DTC 5301.

[48] See, for example, *Vineland Quarries and Crushed Stone Limited v. Minister of National Revenue,* 66 DTC 5092 (Exchequer Court of Canada).

[49] Subsection 251(5).

effective control is broader still and refers to any "direct or indirect influence that, if exercised, would result in control in fact of the corporation" - control in fact here referring again to legal control.[50]

As a consequence of the foregoing, Canadian technology start-ups must exercise care in structuring venture capital investments spearheaded by non-residents or publicly traded corporations (other than venture capital corporations) in order to avoid undermining their status as CCPCs. In early rounds of financing, when venture capitalists typically take only minority positions, legal control usually will not be an issue. However, although staged investments are designed primarily to limit the venture capitalist's risk, the promise of future financing rounds - or, more precisely, the threat of their being withheld - also acts as a strong incentive for founders to grow the company in line with the strategic preferences of the venture capitalists,[51] and perhaps even to select board members favoured by such investors. In the absence of public CRA guidance and case law on point, it is possible that such influence could be viewed as a type of effective control, thus jeopardizing a CCPC's status even during early stage financing. However, shareholder agreements specifying minority board positions for the venture capitalist as well as the addition of neutral, third party board members, which are not uncommon in the initial stage of venture capital financing, could help preclude any imputation of effective control.[52] In later financing rounds, when venture capitalists normally increase their stake to a position of majority control, it may be difficult for a corporation to preserve its status as a CCPC if the venture capitalist is non-resident. Again, loss of CCPC status does not eliminate the income deferral benefit as long as the shares were acquired pursuant to an agreement made when the corporation was a CCPC. However, loss of such status can be of more significance in connection with the lifetime capital gains exemption, as seen below.

### *Deduction from the Employment Benefit*

A second tax advantage associated with shares of CCPCs concerns the employee's ability to deduct one-half of the employment benefit for the purpose of calculating taxable income. In

[50] Subsection 256(5.1).
[51] Gordon Smith, "Control and Exit in Venture Capital Relationships" (2005), at 5 (http://escholarship.org/).
[52] Subsection 256(5.1), supra note 50, has been the subject of what some commentators take to be differing treatment by Canadian courts in *Silicon Graphics Limited v. The Queen*, 2002 DTC 7112 (FCA) and *Mimetix Pharmaceuticals Inc. v. The Queen*, 2001 DTC 1026 (TCC). See discussion in "Control, Silicon Graphics", Income Tax Technical News, No. 25, October 30, 2002. A full discussion of the issues involved is beyond the scope of this paper.

effect, the employment benefit is treated as if it were a capital gain. As with the income deferral discussed above, the employment benefit deduction is available even if the corporation has ceased to be a CCPC after sale or issue of the shares.[53] It is conditional only upon the shares having been held for at least two years prior to disposition.[54] This restriction favours the holder of restricted shares as compared to stock options since vesting periods associated with restricted shares are typically longer than two years and, as already noted, restricted shares are considered to be acquired when received, even though they are subject to unfulfilled vesting conditions. In contrast, an employee who has exercised stock options would not qualify for the deduction in a typical scenario involving a concurrent acquisition and disposition of shares following an IPO or other liquidity event. The employee would be forced to hold the shares for an additional two year period before qualifying for the deduction, creating cash flow issues in many cases since often the proceeds of disposition are used to finance the share acquisition. However, even if the two year holding requirement is not met, an employee disposing of CCPC shares may still be able to take advantage of an alternative deduction of one-half of the employment benefit. Still, this general deduction, which is also available to holders of non-CCPC shares, is only applicable if the shares were acquired at a price no less than FMV at the time the agreement was made[55] and also met certain other prescribed conditions at the time they were acquired.[56] Although common shares generally meet the prescribed requirements, other share properties or terms frequently found in shareholder agreements, such as a right of first refusal or restrictions on dividends, may disqualify them for the general income deduction. Such restrictions, together with the FMV strike price requirement, mean that CCPCs are afforded much greater flexibility in designing stock option and restricted share plans for their employees without jeopardizing the availability of the employment benefit deduction.

### B. Capital Gains and Losses

While any economic benefit attributed to the value of shares above their acquisition price is treated as an employment benefit, as just seen, subsequent increases or decreases in share

[53] Paragraph 110(1)(d.1) simply refers back to subsection 7(1.1), which requires only that the corporation be a CCPC at the time the shares are sold or issued to the employee.
[54] Paragraph 110(1)(d.1).
[55] Subparagraph 110(1)(d)(ii). Provision actually states that ....
[56] Clause 110(1)(d)(i.1)(A). The prescribed conditions are detailed in subsection 6204(1) of the Income Tax Regulations.

value following such acquisition are treated as capital gains or losses in the year the shares are disposed of.[57] Again, such treatment applies equally to both restricted shares and those acquired as a result of the exercise of a stock option. Thus, in a scenario where share value has increased, one half of the difference between the shares' selling price and their adjusted cost base, net of capital losses, will be taxed at the employee's applicable marginal rate.[58] In situations where share value has decreased between the time of acquisition and disposition, the resulting capital loss normally cannot be used to offset the section 7 employment benefit, potentially resulting in the payment of tax in spite of no net economic benefit having been enjoyed - one of the odd and unfortunate results that can obtain because of the application of two distinct taxation regimes (employment income and capital property) to employees' ownership of shares. However, such an offset may be possible where the loss can be characterized as a "business investment loss", which refers to a capital loss arising from the disposition of shares of a "small business corporation" ("SBC").[59] Subsection 248(1) generally defines an SBC as a CCPC, substantially all of whose assets are used principally in carrying on an active business primarily in Canada.[60]

Finally, capital gains resulting from the disposition of the qualifying shares of an SBC are also eligible for a lifetime capital gains exemption of $750,000.[61] The exemption is conditional on the shares having been owned uninterruptedly for the previous 24 months by the individual (or a related person or partnership) and the corporation having been a CCPC throughout that entire 24 month period.[62] This represents the third important element of the favourable tax

[57] Shares are generally held as capital property, which section 54 of the ITA defines as "any depreciable property" and other property, "any gain or loss from the disposition of which would, if the property were disposed of, be a capital gain or a capital loss, as the case may be, of the taxpayer."

[58] The adjusted cost base (ACB) includes the amount of the employment benefit calculated under subsection 7(1) in order to prevent double taxation of that amount as both an employment benefit and a taxable capital gain: paragraph 53(1)(j). This addition occurs irrespective of whether the general deduction in paragraph 110(1)(d) or the CCPC deduction in paragraph 110(1)(d.1) has been made: IT-113R4, supra note 16, at paragraph 20. The ACB of shares is generally calculated by averaging the cost of all shares of the same class (section 47), but note that particular cost-averaging rules are applicable when employees dispose of shares qualifying for the subsection 7(1.1) CCPC income deferral if they also own other shares of the same corporation: subsections. 7(1.31), 47(3). The ACB also includes the price paid to acquire the shares and any fees associated with disposition: IT-113R4, supra note 16 at paragraph 21.

[59] See *Interpretation Bulletin* IT-484R2, "Business Investment Losses", November 28, 1996.

[60] The CRA generally views "substantially all" as referring to 90 percent or more, and "primarily" to 50 percent or more (*Technical Interpretation*, "Small-business Corporation — Principal Use of Assets", March 10, 1998). Although a full discussion is beyond the scope of this paper, it should be noted that aspects of the definition of an SBC raise a number of potential issues for technology CCPCs with substantial business activity outside Canada - for example, those with internationally distributed product development or sales teams.

[61] Subsection 6(1) "qualified small business corporation share", paragraph 110.6(2)(a), subsection 110.6(2.1).

[62] Subsection 110.6(1) "qualified small business corporation share".

treatment of the shares of qualifying CCPCs, the full implications of which are explored in the next section.

### III. Comparing the Tax Treatment of Stock Options and Restricted Shares

As previously noted, the general rules regarding taxation of income from shares sold or issued to employees apply equally to restricted shares and to those acquired through exercise of an option. In each case, both the section 7 employment benefit and any capital gains are taxed at applicable marginal rates after the respective 50 percent deduction. These similarities might cause one to infer that the taxation of income from restricted shares and stock options has identical effects on the taxpayer. Such a conclusion, however, would be incorrect. In fact, there are three factors in particular that from a tax standpoint can significantly favour the issue of restricted shares over options in the context of a start-up. First, the $750,000 lifetime capital gains exemption upon disposition of shares of an SBC greatly advantages the early issue of restricted shares at low (or no) cost. This is because the shares are viewed as acquired when issued, in spite of unfulfilled vesting conditions, so all subsequent share appreciation will be treated as a capital gain, with the first $750,000 exempt from tax altogether. The section 7 employment benefit is calculated at the time of issue and will therefore typically be quite small, possibly even negligible, given minimal share value during the early stages of start-up. In contrast, in an options scenario, since employees often sell shares immediately upon exercising the option following an IPO, the entire economic benefit is treated as an employment benefit; capital gains - and therefore the $750,000 lifetime capital gains exemption and its dramatic effect in lowering the effective tax rate, as will be demonstrated - will not be applicable.

Second, since the FMV of restricted shares is less than shares not subject to the same restrictions,[63] the section 7 employment benefit at the time the shares are acquired will be relatively lower, decreasing the amount of the employment benefit. In the case of options, because acquisition of the shares always occurs after the vesting conditions are fulfilled, any prior discount in the options' value associated with such vesting conditions has no effect on the calculation of taxable income. Finally, significantly fewer restricted shares need to be issued than options in order to confer the same economic benefit on the employee, assuming the options are exercisable at (or close to) FMV at the time of grant (or upon expiry of each vesting period),

[63] See discussion supra at 7.

which is normally the case. If the same strategy is employed across an entire executive team, significant dilution can be avoided, creating more value for investors and making the company more attractive to potential acquirers.[64] If desired, the net effect of these impacts can also be shared between the executive team and other investors when planning the share issue.

The following example illustrates how these differences can result in drastically different effective tax rates where identical underlying economic assumptions are at play. The first scenario assumes the issue of 100,000 restricted common shares to an executive hired during the corporation's formative stages. All shares are issued at no cost to the executive at the time of hiring and their value is discounted 25 percent from the FMV of common shares not subject to the same restrictions, based on an estimate of the probability of the executive's retention by the corporation over the vesting period.[65] The first 25,000 shares are subject to no vesting restrictions and thus operate as a signing bonus. One third of the remaining 75,000 shares vests each year over the following three years. In the alternative options scenario, the executive is instead offered 200,000 options in total in an attempt to confer a roughly similar after-tax economic benefit based on the same anticipated share price appreciation. As in the restricted shares scenario, the first tranche of 50,000 is offered at the time of hiring subject to no vesting conditions. The next three tranches of 50,000 are offered over the next three years, each tranche under a separate options agreement. For each tranche, the exercise price is equal to FMV of the corporation's common shares at the time the tranche is offered. In both scenarios it is assumed that the corporation goes public at the end of year six, permitting disposition of the shares, and the executive has sufficient unused room in his lifetime capital gains exemption to offset any taxable capital gains in their entirety.

[64] Employee options usually range from ten to 15 percent of a corporation's outstanding shares, with perhaps two thirds of the total held by executive team members.

[65] To arrive at the 25% overall discount, I discounted the first tranche of 25,000 shares subject to no restrictions at 0%, the second vesting at the end of year one at 15%, the third vesting at the end of year two at 30%, and the fourth vesting at the end of year three at 50%, each based on the inverse of an estimated probability of the executive remaining in the corporation's employment for each duration, then averaged the discounts over the period.

### Table 1: Comparing Taxation of Restricted Shares and Options

| | Share FMV (w/o restrictions) | Restricted Shares | Options |
|---|---|---|---|
| Executive hired | 1.00 | 100,000 | 50,000 |
| End year 1 | 1.50 | | 50,000 |
| End year 2 | 2.50 | | 50,000 |
| End year 3 | 4.00 | | 50,000 |
| ----- | | | |
| End year 6 - IPO | 6.00 | | |
| Employment benefit | | | |
| S. 7 benefit | | $75,000[66] | $750,000[68] |
| After s. 110 deduction | | 37,500 | 375,000 |
| S. 7 tax payable on disposition | | 16,388[67] | 163,875[69] |
| Capital gain | | | |
| FMV of disposed shares | | $600,000 | $1,200,000 |
| Adjusted cost base | | 75,000[70] | - |
| Capital gain | | 525,000 | - |
| Taxable capital gain | | 262,500 | - |
| Capital gain tax payable | | 0[71] | - |
| Total tax payable on disposition | | 16,388 | 163,875 |
| Pre-tax economic benefit | | 600,000 | 750,000 |
| Effective tax rate | | 2.7% | 21.9% |
| After-tax economic benefit | | 583,613 | 605,663 |

It will be evident that although the same tax rules and rates apply in each scenario, the after-tax effects vary greatly. This is primarily due to *when* the shares are considered to be acquired in each case, since that timing triggers the calculation of the employment benefit and simultaneously initiates application of the capital gains rules. In the case of restricted shares, acquisition occurs at the start of the vesting period, so the vast majority of the shares'

[66] (100,000*1.00*.75) - 0 (FMV discounted 25% due to restrictions; less 0 since shares issued at no cost), calculated on acquisition of shares at hiring.
[67] (37,500*.437). This and subsequent calculations assume the executive pays the current top marginal rate applicable in British Columbia of 43.7%.
[68] (200,000*6.00) - ((50,000*1.00)+(50,000*1.50)+(50,000*2.50)+(50,000*4)), calculated on exercising options post-IPO at the end of year six.
[69] (375,000*.437).
[70] 75,000 + 0 (section 7 benefit plus acquisition cost of zero).
[71] Due to $750,000 lifetime exemption for capital gain on disposal of qualifying shares of an SBC.

appreciation is caught as a capital gain and thus eligible for the lifetime $750,000 capital gains exemption. The fact that the restricted shares are discounted from the FMV otherwise applicable is a much less significant factor. In the example, if the restricted shares were valued at FMV rather than being discounted 25 percent, only an additional $5,463 in tax would be payable and the effective tax rate would still be under four percent, compared to almost 22 percent for options. Again, it should be emphasized that a roughly similar after-tax economic benefit is conferred on the executive in spite of only half the number of shares ultimately being issued in the restricted shares scenario, avoiding considerable dilution of the corporation's share capital. Of course, such dilution must be considered in light of the $450,000 paid by the executive to the corporation for the shares under the options scenario.[72] This amounts to $4.50 per share, considerably under the $6.00 share price post-IPO, so not particularly good value from the corporation's viewpoint, even in simple mathematical terms. Perhaps even more importantly, the additional 100,000 employee options shown in the capitalization table would have had a greater adverse effect on potential investors' evaluation of the opportunity from the very start. Still, it must be emphasized that the tax attractiveness of restricted shares depends greatly on the availability of unused room in a person's lifetime capital gains exemption relating to the disposition of qualifying shares of SBCs and this will be a function of each executive's personal background.

**Conclusion**

The general framework for the taxation of stock options and restricted shares in Canada is the same. Initial economic benefit received at the time shares are acquired is treated as an employment benefit and taxed at marginal rates, while subsequent economic benefit or loss is treated as a capital gain or loss. Both forms of equity compensation share in three general benefits provided the corporation in question is a CCPC: deferral of the employment benefit to the year of disposition of the shares, a deduction in respect to this income inclusion, and a capital gains exemption of up to $750,000 upon eventual disposition of qualifying shares. Nevertheless, the impact of this general taxation scheme on the taxpayer is considerably different depending on whether the shares were issued as restricted shares or options. This difference is due to the combination of the intrinsic nature of restricted shares and options and the peculiar, bifurcated

[72] (50,000 * 1.00) + (50,000 * 1.50) + (50,000 * 2.50) + (50,000 * 4.00).

tax treatment of economic benefit as an employment benefit or capital gain. As explained in section three, the effective tax rate of income derived from restricted shares of a CCPC can be significantly lower than income derived from the exercise of options.

In addition to these benefits, restricted shares offer incentive advantages that should not be underestimated given the current governance climate - one that is likely to continue to prevail. Finally, restricted shares may be less subject to risk from policy changes compared to stock options, which are still the dominant form of equity-based compensation. As such, options may be more likely to remain the specific target, as they were in the 2010 budget, of changes designed to reduce associated tax expenditures, which most Canadians do not value.[73] As these factors illustrate, the choice of an appropriate mechanism for equity compensation of executives in a particular technology start-up in Canada will be driven by a range of considerations beyond the purely economic aspects of taxation this paper has mostly emphasized.

[73] See remarks at note 1 supra. I note, however, that the 2012 federal budget, just released, supra note 41, does not appear to contain any further changes of consequence. Also, since many provisions of the ITA apply both to restricted shares and options without distinction, restricted shares may or may not be impacted by specific policy changes primarily targeting options.

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