CROSS-BORDER INCENTIVE PLANS:

ONE SIZE DOES NOT FIT ALL

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To recruit and retain highly skilled and experienced executives, companies must offer innovative and attractive compensation packages. Variable compensation is an increasingly important element of overall remuneration as businesses seek to link remuneration to performance over both the short and long term.

Businesses with cross-border operations often seek to harmonize compensation packages for senior level employees where possible. As a result, it is common for such organizations to have Canadian employees participate in existing U.S. long-term incentive plans.

There are, however, several key differences between the tax and employment laws in the U.S. and Canada (and even differences between jurisdictions within Canada). These differences mean that incentive plans drafted to comply with U.S. rules and best practices may need to be modified for use in Canada to ensure that the arrangement meets the business objectives on both sides of the border and does not result in unintended legal consequences. This white paper will explore some of these differences and highlight key issues that corporate counsel should consider when utilizing U.S.-style incentive arrangements for Canadian employees.

DESIGN OPTIONS

Businesses have various objectives for implementing long-term incentive plans, including linking compensation to performance of the business over a period longer than one year and encouraging employee share ownership. A key driver in the design of long-term incentive plans is the tax treatment of the award for both the employer and the employee.

In Canada, compensation is typically taxed in the year the employee receives (or constructively receives) the payment. However, if an employee is entitled to receive an amount in a future year and the arrangement meets the definition of a salary deferral arrangement (SDA), the deferred compensation is taxable in year one and subsequent increases in value (e.g., where the original deferred amount increases with share price) are taxable during the deferral period. As a result, SDAs may result in tax being payable by an employee and the employer being required to withhold, remit and report tax before the employee actually receives payment (or even knows what that payment will be).

Canadian long-term incentive plans are, therefore, typically designed to fit within one of the exceptions to the SDA definition or within the stock option rules under the Income Tax Act (ITA).

STOCK OPTION PLANS

In Canada, a stock option plan is the most tax-efficient long-term incentive arrangement from an employee perspective, and U.S.-style stock option plans typically work well for Canadian employees. Stock options in Canada are generally taxed on exercise, not on the date of grant, and the "in-the-money" amount (i.e., the difference between the exercise price and the fair market value, or FMV, of the shares at the time of exercise) is included as income for the employee in the year of exercise. On disposition of shares acquired pursuant to the option, capital gain/loss treatment will be applied to any increase or decrease in share value after exercise.

In Canada, the primary tax advantage of granting stock options is the potential for employees to receive, if certain conditions are met, a 50 percent tax deduction against the "in-the-money" amount. This results, effectively, in capital gains treatment, as only 50 percent of a capital gain is subject to tax under the ITA. These conditions are quite detailed, but they generally require the shares to be "prescribed shares" (essentially plain vanilla common shares not subject to repurchase by the issuer or a significant shareholder), the recipient to be arm's length from the company and the option to have an exercise price not less than FMV on the date of grant.

RESTRICTED STOCK AWARDS

Restricted stock awards (RSAs) are another type of share-based plan popular in the U.S., in which stock is issued to employees with certain restrictions (e.g., vesting conditions) and the employee is not permitted to sell or transfer the stock until the conditions have been satisfied. If the conditions are not satisfied, the employee forfeits the stock.

Key differences between RSAs in the U.S. and Canada are:

- **Timing of the income inclusion:** In the U.S., the value of the RSA is included in income when the conditions have been satisfied (i.e., on vesting) unless a section 83(b) election is filed, which accelerates the recognition of income to the date of grant. In Canada, the value of the RSA is always included in income on the date of grant.
- **Valuation:** In the U.S., utilizing a liquidation valuation (i.e., valuing the award as if the company were to liquidate its assets) is considered acceptable and can result, in certain situations, in the RSA having a nil or very low value on the date of grant. In Canada, this is not an acceptable approach, and the FMV of the RSA will likely have some value (although it should be noted that in Canada, the FMV may take into consideration the restrictions placed on the stock).

RSAs for Canadian employees may be appropriate in certain circumstances -- such as if the shares have a very low FMV after taking into account the impact of the restrictions -- but RSAs are often not the most tax-efficient way to compensate employees in Canada, as employees may have adverse tax consequences if they forfeit the shares.

PROFITS INTEREST

An increasingly common compensation arrangement for U.S. partnerships and LLCs is to grant a "profits interest" to senior level employees, which allows them to share in future profits. In Canada, there is no specific concept of "profits interest" under the existing tax regime. What this means is that, in Canada,

the details of the particular arrangement must be assessed to determine whether the "profits interest" is a grant of security (and can arguably be treated as capital in the hands of the individual) or a promise of future earnings distributions (which may be considered employment income). Although there is no specified regime for profits interests in Canada, if designed properly, they can be an effective method for compensating Canadian employees when a U.S. partnership or LLC is involved.

PHANTOM EQUITY PLANS

Although not as tax-efficient for employees in Canada as stock options, U.S.-style phantom equity plans (e.g., restricted stock units, or RSUs) generally work fairly well in Canada. Employees are granted "units," and each unit typically represents one

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share of the company. The units then track the share value, and additional RSUs can be granted to reflect any dividend payments. RSUs often include time or performance-based vesting conditions and are settled in either shares or cash. The value of the shares or cash received by the employee is included in income.

While U.S.-style RSU plans in Canada generally work well, the main takeaway for employers who use RSUs in Canada is that, if the RSUs are not required to be settled in shares issued from treasury, the awards must be settled within three years of the year in which the grant relates in order to escape taxation under the SDA rules.

DUAL TAXPAYERS

Another consideration in the design of cross border plans is whether there are any participants who are both Canadian and U.S. taxpayers. If so, the company may need to ensure that the plan complies with rules on both sides of the border and also may be required to withhold and remit tax to both the Canadian and U.S. authorities.

SPECIFIC PLAN TERMS

Long-term incentive plans often contain certain definitions, as well as provisions relating to the vesting of awards on "termination of employment," restrictive covenants and clawbacks that give rise to specific issues in the Canadian context.

DEFINITIONS OF "JUST CAUSE" AND "DISABILITY"

In Canada, termination of employment for "cause" is very difficult to prove and is generally determined with reference to common law principles. Definitions of "disability" must also reflect certain accommodations and other human rights obligations relevant to employers in Canada. As a result, definitions of cause and disability found in U.S. plans may not be easily transferrable to Canada.

VESTING ON TERMINATION OF EMPLOYMENT

U.S. and Canadian long-term incentive plans often contain vesting conditions for awards, and the intention of many organizations is that vesting shall not occur after employment ends. However, there is no concept of "at will" employment in Canada, and the employee is generally entitled to notice of termination under employment standards legislation and the common law. In this respect, Canadian courts have found that "termination date" may be interpreted to mean the date on which employment has "lawfully" terminated (i.e., at the end of the applicable notice period). Without careful drafting of the vesting provisions, there may be unintended vesting that continues after a Canadian participant ceases to provide services.

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RESTRICTIVE COVENANTS

A common design feature that we see in U.S. long-term incentive plans is the inclusion of restrictive covenants (RCs), such as post-termination non-competition and non-solicitation covenants. Incentive plans may also include confidentiality provisions, intellectual property provisions and other measures to protect a company's goodwill in the post-termination period, such as non-disparagement covenants. Without careful drafting with regard to Canadian employment laws, however, these provisions may turn out to be little more than ink on paper for Canadian employees.

In general terms, Canadian courts view non-competition covenants as contrary to public policy and a "restraint of trade." Such covenants are rendered unenforceable unless the employing entity can demonstrate that it has legitimate business interests in need of legal protection that cannot otherwise be protected by less intrusive means. Further, all RCs must be narrowly drafted with respect to temporal and geographic scope, as well as the scope of activities restricted, in order to be enforceable.

For RCs that fail to pass muster in the U.S., many jurisdictions will simply modify or read down the covenants, but in Canada, courts do not "blue pencil" provisions. Instead, Canadian courts will generally find that the RC is unenforceable in its entirety and sever the entire provision from the plan. Also noteworthy is that, for employees located in Quebec, if employment is terminated by the employer without cause, a non-competition covenant entered into prior to termination of employment will not be enforced.

CLAWBACKS

In contrast to the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which require clawbacks from compensation received by U.S. executives in certain circumstances, there are no statutory requirements in Canada for employers to have clawback policies. Some (mainly public) companies do include clawback provisions in their arrangements, and this is something that many regulators and shareholder advisory service providers encourage. The terms of clawback provisions in Canada must be clearly and carefully stated in the plan documents and properly disclosed to employees to maximize the likelihood of enforceability under Canadian employment laws.

CORPORATE GOVERNANCE

No matter the plan's design, long-term incentive arrangements must be established and administered within a framework of good corporate governance. Both the terms of the compensation arrangement and each individual grant need to be documented appropriately and approved by the granting body's board of directors (or other party authorized under the terms of the plan, such as a compensation committee). Good corporate governance that requires documentation of awards and supports the valuation used is necessary to help protect both the company and the employee from scrutiny by tax authorities.

CONCLUSION

Harmonizing long-term incentive plans across the U.S.-Canada border is often a laudable objective and aims to provide consistency in compensation for senior-level employees and maximize administrative efficiencies. However, in order to attain these objectives and avoid unintended consequences, it is vital to understand the key differences between the tax and employment law regimes in the U.S. and Canada. Such an understanding will allow organizations to effectively implement cross-border arrangements and appropriately adapt them for use in the Canadian market.

ABOUT BLAKES

As one of Canada's top business law firms, Blakes provides exceptional legal services to leading businesses in Canada and around the world.

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[1] This paper is intended to be a high level discussion on the topic and does not constitute tax planning or legal advice.

[2] See section 110(1)(d) of the ITA and section 6204 of the Income Tax Regulations.