THE UPDATE

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Corporate Securities

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Rethinking Stock Options

In recent months, a significant number of public companies have started to re-examine the use of stock options as a means of compensating their employees. Many are considering replacing their stock option plans with plans providing for outright grants of restricted stock. This process has largely been the result of the downturn in public stock markets, resulting in employees holding "underwater" stock options that are not fully effective as an employee incentive. In addition, the mounting pressures on companies to expense stock option benefits have also affected companies' decisions to review their stock-based incentive programs.

A restricted stock award is a grant of stock by an employer to an employee in which the employee's rights to the shares are limited until the shares vest and cease to be subject to the restrictions. The employee may not sell or transfer the shares until they vest and forfeits the shares if the employee's employment terminates before vesting occurs. Vesting may be time or performance based. Once vesting occurs, the employee obtains full ownership of the shares.

While the introduction of restricted stock award plans may be desirable from many perspectives, it may not produce the most desirable tax results for Canadian employees. A Canadian employee who receives a restricted stock award from a public company would generally be required to include the fair market value of the shares in computing his or her employment income for the year in which the shares are received. As these shares are typically subject to restrictions on transferability, the employee generally is precluded from selling the shares until the end of the vesting period, which may cause the tax burden to be particularly onerous to the employee. Although the Canada Customs and Revenue Agency acknowledges that a reasonable discount may be applicable in determining the fair market value of the shares subject to transfer restrictions, this is little consolation for the employee who is unable to monetize the restricted stock award to meet his or her tax liability.

Under a typical restricted stock award, if the employee does not meet certain vesting requirements, the shares are forfeited by the employee. An employee who forfeits the shares would realize a capital loss at the time of forfeitures equal to the fair market value of the shares at the time they were received (i.e. the amount required to be included in the employee's employment income upon the grant of the restricted stock). Such capital loss may be carried back three years and carried forward indefinitely, but this does not provide satisfactory tax relief to the employee as the capital loss may not be used to shelter employment income or other ordinary income, and only one-half of the capital loss may be used to offset taxable capital gains.

Because of the difficulties associated with the tax treatment of the employee under a restricted stock award plan, public companies considering awards of restricted stock to Canadian employees may wish to consider the alternative of using "restricted stock units". Under this type of a plan, the employee does not receive actual shares at the date of grant, but instead is awarded "restricted stock units" that represent the right to receive shares if certain vesting requirements are met. If those requirements are met within the vesting period, the employee would be entitled to receive, without any additional payment, a specified number of shares at the end of the vesting period. If the requirements are not met within the vesting period, the employee would forfeit the restricted stock units, including any rights to receive the underlying shares.

As in the case of a restricted stock award plan, the company would not be entitled to a deduction for shares issued under a restricted stock unit plan. However, the tax consequences of a restricted stock unit plan are more favourable to the employee. The employee is not taxed at the time of the grant of a restricted stock unit, but if the vesting requirements are met and the employee actually receives shares at the end of the vesting period, the employee will be taxed on the value of the shares at that time. If the vesting requirements are not met and the employee forfeits the restricted stock units, there would be no tax consequences to the employee. This tax treatment better aligns the employee's tax liability with his or her actual ability to fund that liability. Accordingly, a restricted stock unit plan may be a useful alternative for public companies considering the outright grant of restricted stock to Canadian employees.

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