November 26, 2020

SELECTED COMPENSATION STRATEGIES FOR ATTRACTING AND RETAINING TOP TALENT IN THE CANADIAN TECH SECTOR

The demand for top talent in the Canadian tech sector has motivated many employers to design appealing, tax-efficient compensation structures to attract and retain employees. These structures often go beyond cash compensation, and may involve share grants, stock options or other creative alternatives.

The following is a high-level summary of selected compensation strategies that are viable alternatives to cash compensation and some of the key Canadian tax considerations associated with those strategies.

Corporate Equity Models

Equity-based compensation arrangements can take many forms, ranging from formal equity ownership to contractual arrangements that provide the economic equivalent.

Important non-tax considerations for equity-based plans

- Excellent way of compensating employees, especially in the start-up phase when the business is not generating significant net cash flow
- Improves alignment of employee and shareholder interests and provides a long-term incentive for employees
- Dilution of existing shareholders must be considered
- Challenges in dealing with minority shareholders can be mitigated with a unanimous shareholders' agreement or other tools
- Lack of liquidity for employees can be addressed with a corporate repurchase arrangement or a buy-sell arrangement

Employee share grants[1]

- Involves a direct issuance of shares to an employee, either as base compensation or as a reward for exceptional performance
- Taxable employee benefit amount equal to the difference between the value of the shares at the time of acquisition and the amount paid for the shares
- Only 50% of the benefit is taxable if the employee holds the shares for at least two years or if certain other requirements are met
- Generally no taxable benefit to the employee until they dispose of the shares, provided that the employee deals at arm's length with the corporation
- Potential tax trap if the share decreases in value after acquisition but before disposition
- Withholding of tax not required by the employer
- Share terms can be designed to achieve specific objectives – *e.g.*, consider "tracking shares" where the value of the shares is dependent on the performance of a particular project or segment
- If the value of the shares is low, consider whether the employee can subscribe for shares as a founder rather than receive a share grant as an employee

Employee stock options

- Options are issued to employees to acquire shares at a pre-determined price for a period of time
    - Can require a period of time to pass before the employee is entitled to exercise the options or make the exercise of the options conditional on certain events (*e.g.*, sale of the business, attainment of certain financial targets, *etc*.)
- Taxable employee benefit amount equal to the difference between the value of the shares at the time of acquisition and the amount paid for the options and the shares
- Only 50% of the benefit is taxable if the employee holds the shares for at least two years after the options are exercised or if certain other requirements are met
- Generally no taxable benefit to the employee until they dispose of the shares, provided that the employee deals at arm's length with the corporation
- Potential tax trap if the shares decrease in value after acquisition but before disposition

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[1] The comments herein on employee share grants and employee stock options assume the corporation is a Canadian-controlled private corporation.

- Withholding of tax not required by the employer
- If certain conditions are met, the employee can exercise their stock options on a cashless basis

Phantom share plans

- Shares are not actually issued; the plans are designed to calculate cash compensation based on increases in the value of the corporation’s shares
- Examples: restricted share units, performance share units, deferred share units, share appreciation rights, *etc*.

Selected Alternatives to Corporate Equity

Net Profits Interest Royalty (NPI)

- Where the prospective employee brings no promising technology with them – only a promising skill set – so that a “net sales revenue” royalty is inappropriate, an NPI type of royalty may be suitable and attractive to both employer and employee
- An NPI is a well-understood interest used in the oil and gas industry for many decades, including as a tool to attract and retain key employees
- “Net profits” can be defined in a variety of ways, broadly or narrowly, including on a “net cash flow” basis; some creativity and drafting skill is required
- The entitlement percentage can be as small or as large as is appropriate in the circumstances and can be based on the entire business or simply a project or segment thereof
- An NPI is a separate stand-alone property but generally does not encumber any underlying assets of the business
- The employer can grant the NPI or it can be purchased by the employee
- Taxable employment benefit in the year the NPI is acquired by the employee equal to the difference between its value at the time of acquisition and the amount paid therefor
    - The value of such an NPI often is modest if it is acquired in the first few years of a business that is developing new and unproven technology
- Payments received under the NPI should be considered income from property — not from employment — and consequently the employer should not be required to withhold amounts for income tax, CPP and EI

Limited Partnership (LP) Interest

- LP interests are frequently used and well understood; some of the relevant rights, obligations and limitations are set out in the relevant provincial *Partnership Act* and in the federal *Income Tax Act*
- The owner of an LP interest generally is entitled to a share of profits but has limited responsibility for any losses
- The LP percentage interest could be as small or as large as is appropriate in the circumstances
- A limited partner is a "silent", inactive partner – to maintain limited liability, the LP interest would be granted to or purchased by a related person, such as a spouse or holding corporation, that has no active involvement with the employer
- Taxable employment benefit in the year the LP interest is acquired by the related person equal to the difference between its value at the time of acquisition and the amount paid therefor
    - The value of such an LP interest often is modest if it is acquired in the first few years of a business that is developing new and unproven technology
- Payments received from the LP interest should be considered income from business — not from employment — and consequently the employer should not be required to withhold amounts for income tax, CPP and EI