DEFERRED SHARE UNIT PLANS

The Limitations of Deferred Share Unit Plans

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In the context of the Income Tax Act,[1] long-term employee incentive plans have, traditionally, had three main goals: (i) to reward and encourage employees through some form of equity participation in the employer; (ii) to defer taxation of the employee until economic receipt of the benefit; and (iii) to permit the employer to deduct the amount of the incentive payment. Recently, there has been a proliferation of phantom stock plans, referred to as Deferred Share Unit ("DSU") plans, which satisfy these goals. The purpose of this article is to summarize the application of the provisions of the Act which permit the issuance of DSUs and to highlight certain of the potential limitations of such plans.

Regulation 6801(d)

Most arrangements which attempt to defer an employee's compensation beyond the year in which it is earned will generally be at risk of being classified as a salary deferral arrangement ("SDA"). The actual definition of SDA in subsection 248(1) is detailed, but, in summary form, an SDA is, subject to certain exceptions, any arrangement under which an employee has a right in a taxation year to receive an amount on account of salary for services rendered in the year after that year and it is reasonable to assume that one of the main purposes for the creation or existence of the right is to postpone the tax payable on the amount. If a particular plan is found to be an SDA, the employee will be subject to tax in the taxation year in which the right arises even though such employee might not necessarily receive any amounts in that year,[2] causing a potentially harmful economic result.

The exception to the SDA rules which is the subject of this article is that contained in paragraph (*l*) of the SDA definition for a "prescribed plan or arrangement." For this purpose, in 1991, the Department of Finance introduced Regulation 6801(*d*) to allow an exemption for DSU plans. To qualify, the following conditions must be met in respect of the plan:

1. the written arrangement must be between a corporation and an employee of the corporation (or of a corporation related thereto);

2. any payment made under the arrangement must be reasonably attributable to employment duties performed by the employee of behalf of the corporation (or a corporation related thereto);

3. all amounts received under the arrangement must be received after death, retirement, or termination

of employment (the "Payment Events");

4. all amounts received under the arrangement must be received before the end of the calendar year following the year in which a Payment Event has occurred;

5. the amount of the payment must be determined based upon the fair market value ("FMV") of the shares of the employer corporation (or the related corporation) within one year of the occurrence of a Payment Event; and

6. neither the employee nor a person dealing at non-arm's length with the employee can be entitled, either immediately or in the future, either absolutely or contingently, to receive or obtain any benefit granted or to be granted for the purpose of reducing the impact, in whole or in part, of any reduction in the FMV of the shares of the corporation (or the related corporation).

Typical DSU Plan

In a typical DSU plan participating employees are granted DSUs the value of each of which is notionally equal to the current FMV of one share of the corporation, although no actual shares are issued by the corporation. In the period between the granting of the DSUs and the payment in respect of such DSUs, the employee is also credited with additional DSUs having a notional value equal to dividends paid on the actual shares of the corporation. In this way, the employee receives the same benefit as if he or she had owned shares of the corporation rather than phantom units.

The provisions of the DSU plan will typically provide for vesting conditions, which are varied in practice but can include things such as the passage of a period of employment with the corporation or the satisfaction of certain performance criteria such as the achievement of corporate earnings. Once the stipulated conditions are met, the DSUs will vest in the employee.

The employee then holds these vested DSUs until death, retirement or termination of employment, whereupon the employee (or in the case of death, the employee's beneficiary) will be entitled to a cash payment equal to the value of the DSUs (i.e., the current value of the corporation's shares). In this way, a DSU plan provides a long-term link between the corporation's performance and the employee's ultimate level of compensation.

Some DSU plans are structured so that the corporation or the employee can choose that the payment, net of applicable source withholdings, be made by way of shares of the corporation rather than cash, in which case the corporation can either issue shares from treasury to the employee or transfer the cash amount to an independent broker who will then purchase the shares on the open market on behalf of the employee.

If structured properly, the amount received by the employee under a DSU plan will be taxed as employment income pursuant to subsection 5(1) in the year the payment is received and not before then. Notably, however, the amount of the payment will be treated as ordinary income. As such, under this type of plan, employees do not receive the same preferential income tax treatment potentially available under an employee stock option plan.[3] Upon making the payment in respect of the DSUs, the corporation will generally be entitled to a deduction in respect of any cash payment made to the employee or the independent broker. However, as is the case with traditional stock option plans, the corporation will be denied a deduction in respect of any payment made via a share issuance from treasury.[4]

Limitations

DSU plans are favourable vehicles for many employers in that they serve to effectively link the corporation's performance with the employee's actual compensation while, simultaneously, permitting the employer a deduction and deferring the employee's compensation.

However, Regulation 6801(*d*) contains some significant limitations which must be kept in mind. In this connection, it is worthwhile noting that the recent proliferation of DSU plans may cause the Canada Revenue Agency (the "CRA") to scrutinize such plans more closely than was their previous practice.

A key limitation is that DSUs can only be issued by a corporation to employees of a corporation. Therefore, DSUs cannot be granted by partnerships or mutual fund trusts. This anomalous result, which does not seem to be supportable in policy terms, has been confirmed by the CRA in its sole published commentary dealing with the applicability of the DSU exception to the SDA rules to partnerships. In that *Document*, the CRA indicated that the DSU exception could not be modified to accommodate partnerships, stating, in part, as follows:

> The fact that an arrangement may be designed to operate in a manner that is similar to the exception to the SDA provisions [in respect of DSUs] will not result in the particular arrangement being excluded from the SDA provisions. With respect to the [DSU] exception, only arrangements that clearly fit within those provisions will be excluded from the definition of an SDA. Consequently, an arrangement that provides for the investment of deferred salary in notional units of an employer partnership will not be exempted from being an SDA under [the DSU exception].[5]

In the case of a partnership or mutual fund trust, it might be possible for the employees to have parallel employment agreements with the general partner corporation or the management corporation and for that corporation to issue the DSUs. However, the difficulty in such a case would be that the value of the DSUs could not be calculated by reference to the value of the partnership units or the trust units, which might be the publicly traded entity. Rather, the provisions of Regulation 6801(*d*) require that the value of the DSUs be calculated by reference to the value of the corporation's shares. While it may be possible to structure such a DSU plan so that the value of the corporation's shares parallels the value of the partnership or trust units, such an arrangement may not be acceptable or even practical from a business perspective.

Another emerging limitation is in respect of recent indications from the CRA that it may no longer accept DSU plans where the number of DSUs to be granted is left to the sole discretion of the board of directors of the employer corporation. In this respect, the CRA has previously issued a multitude of Rulings accepting such provisions. However, the CRA's concern is apparently that such discretionary grants may serve to violate the sixth criteria above that the employee not be entitled to obtain any benefit to be granted for the purpose of reducing the impact of any reduction in the FMV of the shares of the corporation. Historically, this condition has been dealt with by the inclusion of a clause similar to the following in all DSU plans:

> Notwithstanding any other provision of this Plan, no amount will be paid to, or in respect of, a Participant under this Plan or pursuant to any other arrangement, and no Deferred Share Units will be granted to such Participant to compensate for a downward fluctuation in the value of any Shares in the capital of the Corporation nor will any other form of benefit be conferred upon, or in respect, of a Participant for such purpose.

However, recently, the CRA has become more concerned about this requirement and may no longer be satisfied by the mere inclusion of a clause such as the foregoing. The CRA's concern in this regard is best shown by way of an example. Assume that the directors of the corporation can grant, in their sole

discretion, any number of DSUs to directors and executives but that it is the general practice of the corporation to issue each employee $5,000 worth of DSUs a year. Such a grant is made in year 1. Further assume that, in year 2, the shares of the corporation drop dramatically in value and are now worth only $1,000 with the result that the DSUs issued in year 1 are now also worth only $1,000. The CRA's concern in this regard is that in year 2, the board of directors would exercise their discretion to issue $9,000 worth of DSUs in order to compensate the participants for the drop in value and that this issuance would be in direct contravention of the requirements of Regulation 6801(*d*). This begs the question, of course, of why the corporation would choose, from a business perspective, to make such a grant.

In order to avoid the foregoing concern, the CRA has indicated to the author that DSU plans should contain some sort of formula or other means of determining, in advance, how many DSUs will be granted, and further, that such formula relate to duties provided by the employee. A purview of Rulings issued in the last few months indicates that an accepted approach is for the provisions of the plan to provide that the board of the corporation can make discretionary awards but only up to a specified cap of the participant's regular salary.

The basis of the CRA's position is apparently that such a cap will serve to prevent the corporation from choosing to issue extra DSUs to compensate for a previous drop in value.

Conclusion

While DSU plans constitute an innovative compensation vehicle which permit equity-like participation by employees in their corporate employer while at the same time providing the employer with a valuable tax deduction, such plans do have inherent limitations which should be carefully examined prior to implementation.[6] In particular, the tax consequences to the employee of an improperly formulated plan constituting an SDA can be punitive in nature.

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[1] R.S.C. 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the "Act." Unless otherwise stated, statutory references in this article are to the Act.

[2] Pursuant to subsection 6(11) and paragraph 6(1)(*a*).

[3] In particular, the 50% deduction provided for in paragraphs 110(1)(*d*) or 110(1)(*d*.1) will not be available in respect of DSU plans.

[4] Paragraph 7(3)(*b*). The CRA has provided positive rulings stipulating that paragraph 7(3)(*b*) will not apply where a cash amount is transferred by the corporation to an independent broker who uses the amount to purchase shares on behalf of the employee.

[5] CRA *Document* 2001-0072445, "Partnership salary deferral arrangement or employee benefit plan arrangement" (April 12, 2001).

[6] To achieve similar tax results, it may sometimes be worthwhile for the corporation to issue stock options whereby the employee can elect to surrender the options for a cash payment of the in-the-money value of such options.

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