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The Unexpected Tax Benefits of Post-Vest Holding Requirements in Canada

Canada offers extra tax benefits for equity awards with mandatory holding periods, making them even more attractive to employers. We explain how to maximize the benefits.

Share awards subject to post-vest holding requirements are an emerging trend in the United States (US) that will likely increase in popularity in Canada because of tax and accounting-related benefits. In the US, there are accounting discounts for post-vest holding requirements, but the Canadian tax system provides additional benefits. This article explores what these tax benefits are and recommendations for designing post-vest hold requirements that comply with the Canadian regulatory environment.

How to Apply Discounts

Post-vest holding requirements are a different, and in many cases better, approach to obtaining the governance benefits of minimum shareholding requirements. A minimum shareholding approach requires that an executive's investment portfolio contain at least a specified number of employer shares, whereas a post-vest holding period requires that the specific shares obtained under an equity award continue to be held for a minimally required period of time. Minimum shareholding requirements are viewed favorably by both institutional shareholders and proxy advisory firms, and generally improve an issuer's governance ratings, which can provide a boost to say-on-pay results. Yet, while the minimum shareholding approach provides greater flexibility and high-level benefits to a company, the tax benefits associated with shares that carry post-vest holding restrictions ultimately makes them more preferable to employers and award recipients.

There is typically a reduction in the fair value of shares with post-vest holding periods since these provisions result in a temporary loss of liquidity. For accounting purposes, the expense to be recognized for compensation paid in shares is based on fair value and its reduction translates directly into reduced compensation expense for companies.

In Canada, holding requirements can also result in a reduction in tax for the executive. Under Canadian tax rules, holding requirements that reduce the value of a share also reduces the taxable value of the benefit obtained by an executive receiving the share; therefore, executives will report a smaller taxable income from the awards. The adjusted cost base for the purposes of calculating capital gains or losses upon disposition of the share is equal to the executive's taxable benefit upon receipt of the share. All proceeds of disposition greater than the taxable benefit will be treated as a capital gain and will be taxed at half the regular rate.

Below is a simple example which assumes the following facts:

- The fair value of XYZ Company shares on the open market is $10 at vesting
- The total value of the award that vests is $100,000
- Executive A and Executive B receive a stock award that vests at $100,000
- The awards have a tax rate of 50%

Now, for the specifics about the awards:

- Executive A receives $50,000 worth of Restricted Shares (7,143 shares with a value of $7 each) and $50,000 is remitted in withholding tax
    - These shares are subject to a three-year post-vest holding requirement, reducing the share's fair value from $10 to $7 (a 30% reduction)
- Executive B receives $50,000 worth of unrestricted shares (5,000 shares at $10 each) and $50,000 is remitted in withholding tax
    - These shares have no post-vest holding requirement
- Both executives eventually sell the shares for $20 per share

Here's how we calculate the total tax payable for the Executives:

- Executive A's cost base is $50,000 ($7 x 7,143)
- Executive B's cost base is $50,000 ($10 x 5,000)
- Executive A's proceeds of disposition are $142,857 ($20 x 7,143)
- Executive B's proceeds of disposition are $100,000 ($20 x 5,000)
- Executive A's capital gain is $92,857 ($142,857 - $50,000)
- Executive B's capital gain is $50,000 ($100,000 - $50,000)
- Only 50% of the capital gain is subject to tax. Taxable capital gain is therefore $46,429 for Executive A and $25,000 for Executive B
- Executive A's tax payable in respect of her proceeds of disposition is $23,214 (50% of $46,429)
- Executive B's tax payable in respect of his proceeds of disposition is $12,500 (50% of $25,000)

The net benefit for Executive A under these assumptions is $119,645— almost 37% greater than Executive B's net benefit of $87,500. Meanwhile, the accounting compensation expense for Executive A and B is the same at $100,000.

Some might take the position that the number of shares granted to the executives should be determined using their cost on the market; therefore, only the calculation of the taxable benefit should incorporate the lesser fair value of the restricted shares. What follows is a comparison of Executives A and B under that scenario:

- Both receive 5,000 shares

- $50,000 of withholding tax is remitted in respect of Executive B giving a total settlement value and compensation expense of $100,000
- For Executive A the value of the taxable benefit in respect of the shares is only $35,000 ($7 x 5,000). Of the $50,000 cash portion, taxes are fully paid with respect to both the shares and the cash itself with a withholding remittance of $42,500. This leaves Executive A with $7,500 in tax-paid cash.
- Executive A uses the $7,500 to purchase 750 additional shares
- As before, both executives eventually sell for $20 per share

The net benefit for Executive A under these assumptions is $96,875 with a compensation expense of $85,000. The net benefit for Executive B is $87,500 with a compensation expense of $100,000.

Clearly, under either calculation, Executive A with post-vest holding requirements realizes a material cost-savings benefit.

Next Steps

In our discussions about post-vest holding requirements in the US, we've focused a lot on the accounting savings for employers. In Canada, we're able to expand the cost savings to the individual employees who realize a tax benefit for shares with post-vest holding requirements. While holding requirements may not suit all circumstances, they merit consideration by compensation committees and senior management at Canadian companies to see what cost savings for both companies and employees can result.

To learn more about the potential benefits of mandatory post-vest holding requirements, please visit our website: radford.com/mandatory_holding_periods/. To speak with a member of our compensation consulting group about equity plan design issues, please write to consulting@radford.com.

Author Contact Information

Daniel D. Coleman
Associate Partner
Aon Hewitt
Equity Valuation
+1.312.381.4111
daniel.coleman@aonhewitt.com

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