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Employee stock options

June 9, 2021 Webcast

MAKING AN IMPACT THAT MATTERS since 1845

Agenda and introduction

Webcast 2	Content
June 9, 2021	• Summary of key takeaways of first webinar and 200K annual vesting limit • Deeper dive of the strategic consideration and role of stock options granted in the new legislative environment • Tax technical aspects of the corporate deductibility of non-qualified securities • Tax accounting implications • Where do we go next

Our presenters

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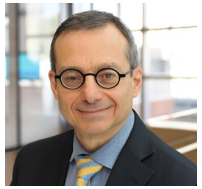

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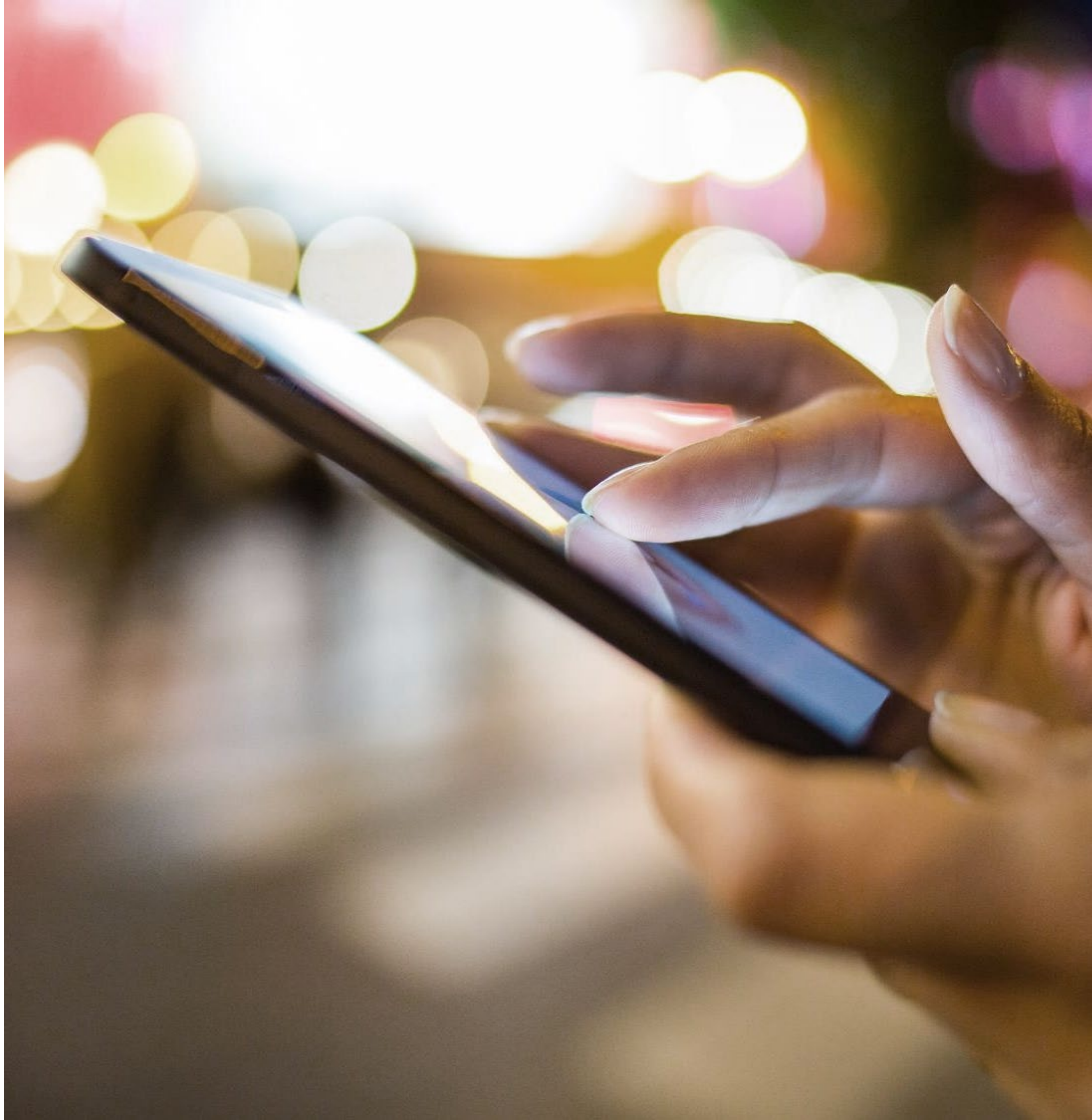
Polling question #1



Summary of key takeaways

Webinar #1

As a summary, during webinar #1, we discussed the following changes to the stock option taxation regime

Employee stock option deduction (favorable treatment) may be **limited** for grants made on or after **July 1,2021**

200k annual limit, per vesting year per employee, is based on the underlying value of shares of the issuer at the time of grant

Employer deduction may be available for options that do not provide for favorable treatment to employees

Self-reflection exercise to perform, **strategic review** of future LTIP design and compensation mix highly recommended

$200k limit: how it works and the impact

Numerical example—Scenario 1: 4-year ratable vesting

Key assumptions:

- **2022 Option Grant:**
  - Share price at 2022 option grant: $50/share
  - # options granted: 20,000
  - Total FMV of options at grant: $1,000,000

Key assumptions:

- **2023 Option Grant:**
  - Share price at 2023 option grant: $50/share
  - # options granted: 20,000
  - Total FMV of options at grant: $1,000,000

Scenario 1	**Total value vesting per calendar year**						
	2022	**2023**	**2024**	**2025**	**2026**	**2027**	**Total**
Total value (2022/2023 grant)		$250k	$500k	$500k	$500k	$250k	$2M
200k allocation		($200k)	($200k)	($200k)	($200k)	($200k)	
Total value Non-qualified options		$50k	$300k	$300k	$300k	$50k	
	Total number of options vesting per calendar year						
Total # Options vesting		5,000	10,000	10,000	10,000	5,000	40,000
# Qualified Options		4,000	4,000	4,000	4,000	4,000	**20,000**
# Non-qualified Options		1,000	6,000	6,000	6,000	1,000	20,000

Employer has the discretion to elect which options (from both the 2022 and 2023 grant) may be designated as non-qualified options. Optimization strategy recommended

$200k limit: how it works and the impact

Numerical example—Scenario 2: 4-year cliff vesting

Key assumptions:

- **2022 Option Grant:**
  - Share price at 2022 option grant: $50/share
  - # options granted: 20,000
  - Total FMV of options at grant: $1,000,000

Key assumptions:

- **2023 Option Grant:**
  - Share price at 2023 option grant: $50/share
  - # options granted: 20,000
  - Total FMV of options at grant: $1,000,000

Scenario 2	**Total value vesting per calendar year**						
	2022	**2023**	**2024**	**2025**	**2026**	**2027**	**Total**
2022 Options Grant					$1M		$1M
2023 Options Grant						$1M	$1M
Total value					$1M	$1M	$2M
200k allocation					($200k)	($200k)	
Total value Non-qualified options					$800k	$800k	
	Total number of options vesting per calendar year						
Total # Options vesting					20,000	20,000	40,000
# Qualified Options					4,000	4,000	**8,000**
# Non-qualified Options					16,000	16,000	32,000

Deeper dive of the strategic considerations

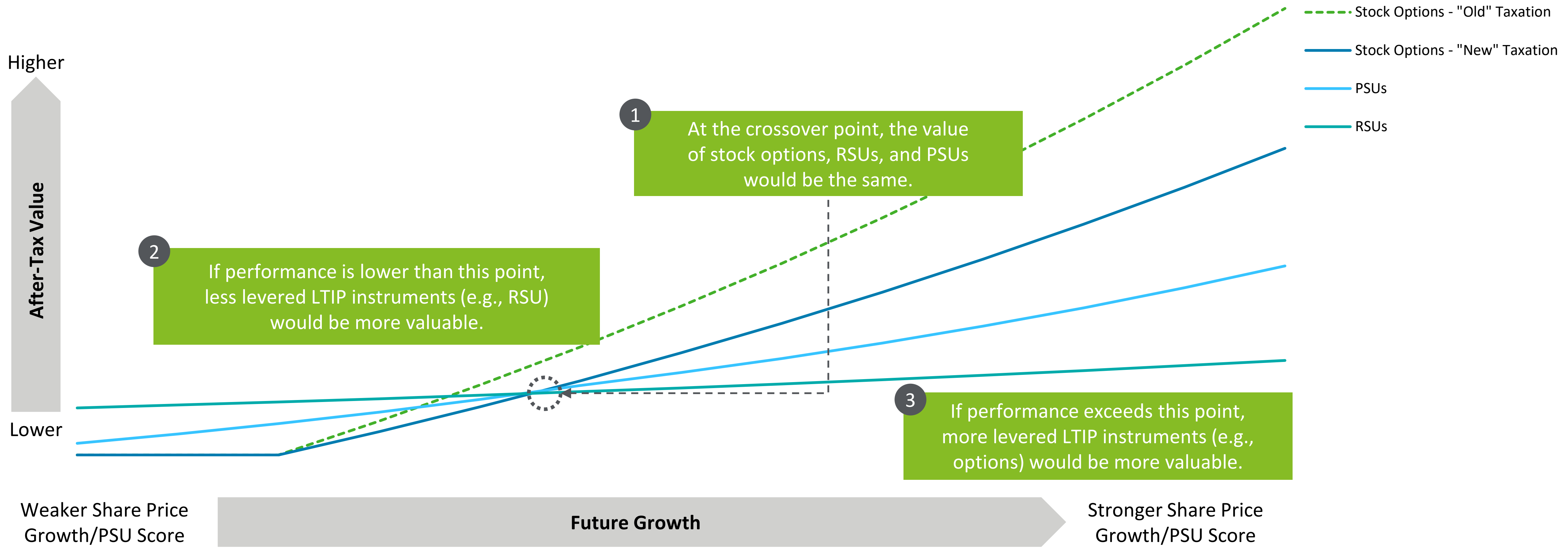
Reasons for a long-term incentive plan (LTIP)

1. Create **alignment** between management and the owners/shareholders
2. Consideration of **other stakeholders** becoming increasingly important
3. Attract and **retention** key talent
4. Ensure linkage between **pay and performance**

Deeper dive of the strategic considerations

Stock options vs. restricted share units (RSU) vs. performance share units (PSU)

The change to option taxation effectively reduces the after-tax value of non-qualified options. This will alter the pay-and-performance leverage and trade-offs between options and alternative LTIP instruments.

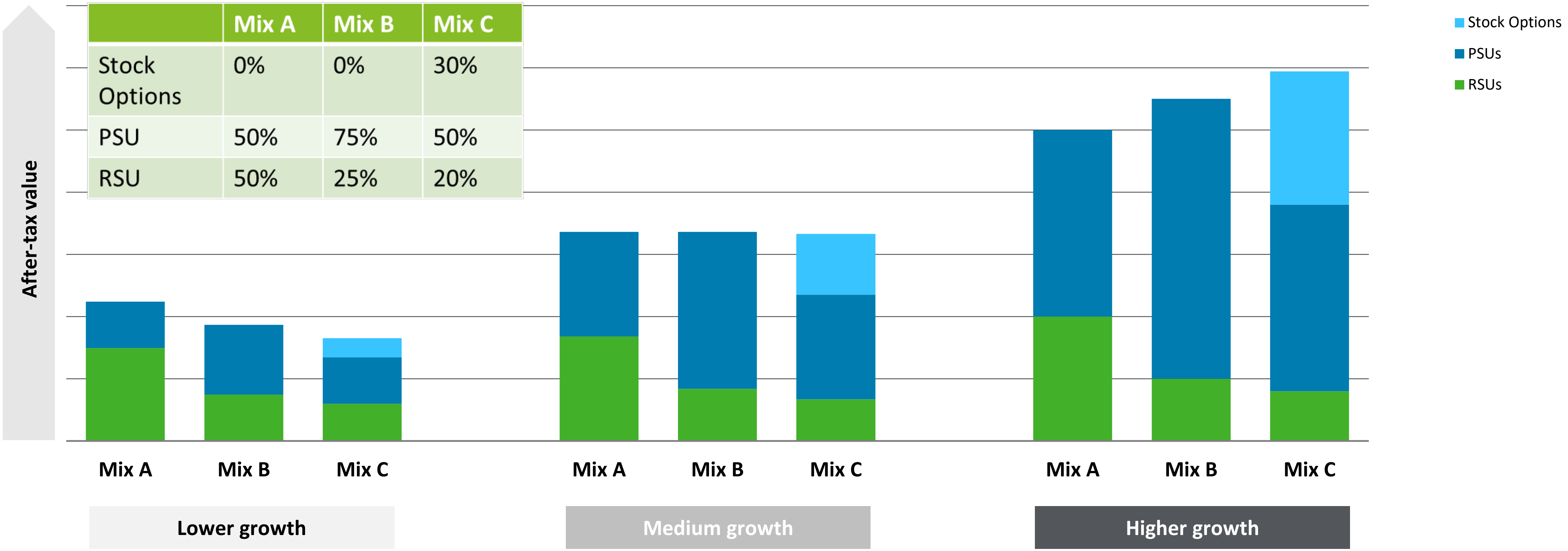


Deeper dive of the strategic considerations

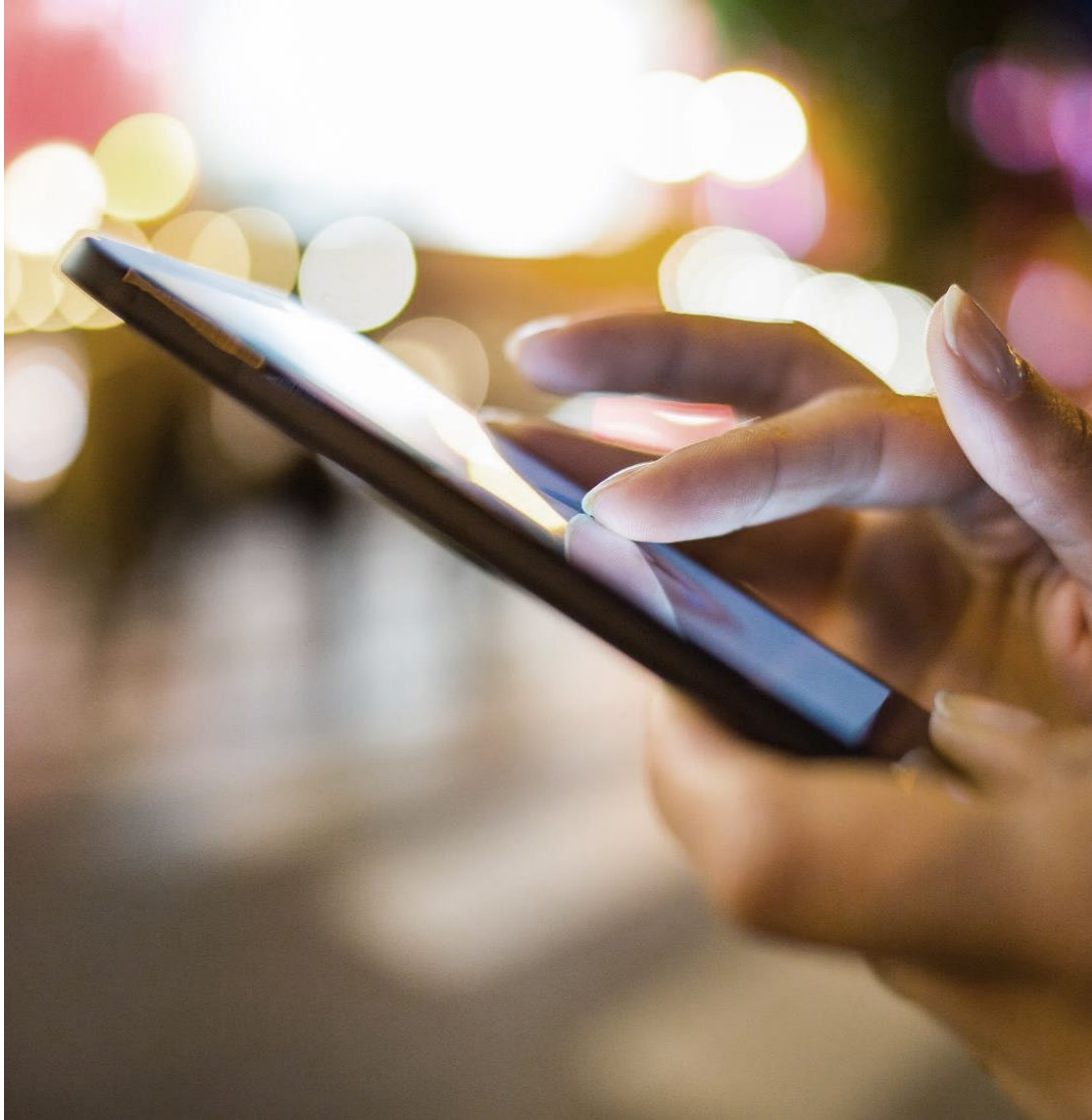
Testing LTIP mix alternatives

Companies will want to reassess the LTIP mix and consider how the changes in stock option taxation affects the choice and mix of LTIP.

	Mix A	Mix B	Mix C
Stock Options	0%	0%	30%
PSU	50%	75%	50%
RSU	50%	25%	20%



Polling question #2



Deeper dive of the strategic considerations

Overview of taxation of share units

Employees are granted units that track the value of the underlying shares (Share Units)

Settlement	Accounting	Does the employee hold a legal binding right to receive treasury shares?	Corporate tax deduction	Deferral period
Cash	Mark to market (variable)	No	Yes	3 years unless there are performance conditions
Treasury (Equity)	Fixed (largely locked in at grant)	Yes	No	Flexible
Hybrid	Mark to market	Yes, but employee chooses cash or treasury shares	Yes if cash No if shares	Flexible

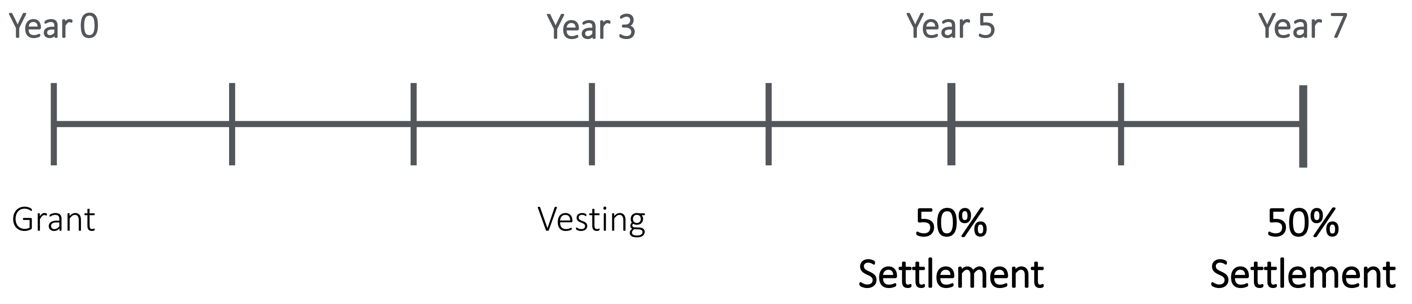
A number of Alternatives Structures—Beyond Mainstream (PSUs, RSUs and Options) follow

These all have a number of structural design choices and issues with various accounting and tax implications

Deeper dive of the strategic considerations

Potential alternatives: long-term RSU and PSU

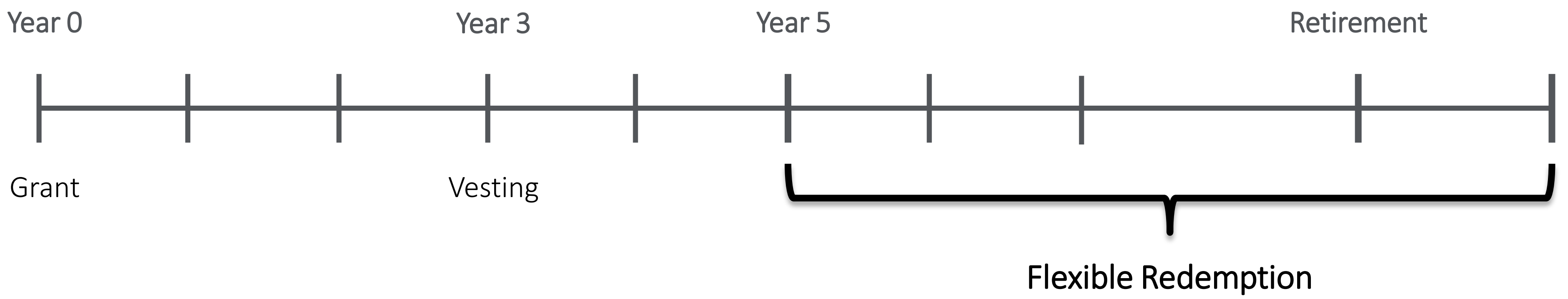
Fixed Settlement Date



Important Tax Considerations

- Settled with newly issued shares
- No corporate tax deduction unless a cash settlement alternative is utilized

Flexible Settlement



Deeper dive of the strategic considerations

Potential alternatives: after-tax ownership with selling restrictions

Award of shares:	**$100,000**
Taxable fair value:	**$60,000**
Taxes payable:	**$30,000**

Selling restrictions
A discount on the FMV can be applied to value the employment benefit at time of grant. This discounted value become the employee’s cost base in the shares

- ✓ Taxable fair value < market value
- ✓ Long-term real ownership
- ✓ No forced liquidation/settlement date
- ✓ Capital gains tax at the time of sale
- ? Need to pay taxes upfront
- ? Some added complexity

Deeper dive of the strategic considerations

Potential alternatives: after-tax ownership with selling restrictions

The use of after-tax shares with selling restrictions will have taxation benefits vs. another instrument like a DSU.

		After-tax shares	DSUs
At grant date	Grant	$100,000	$100,000
	Taxable fair value	$60,000	-
	Taxes payable upfront	-$30,000	-
At settlement/sale to 3rd party	Settlement/sale	$200,000	$200,000
	Capital gain or Income	$140,000	$100,000
	Taxes	-$35,000	-100,000
	Total taxes	$65,000	$100,000
Net	**Amount net of taxes**	**$135,000**	**$100,000**

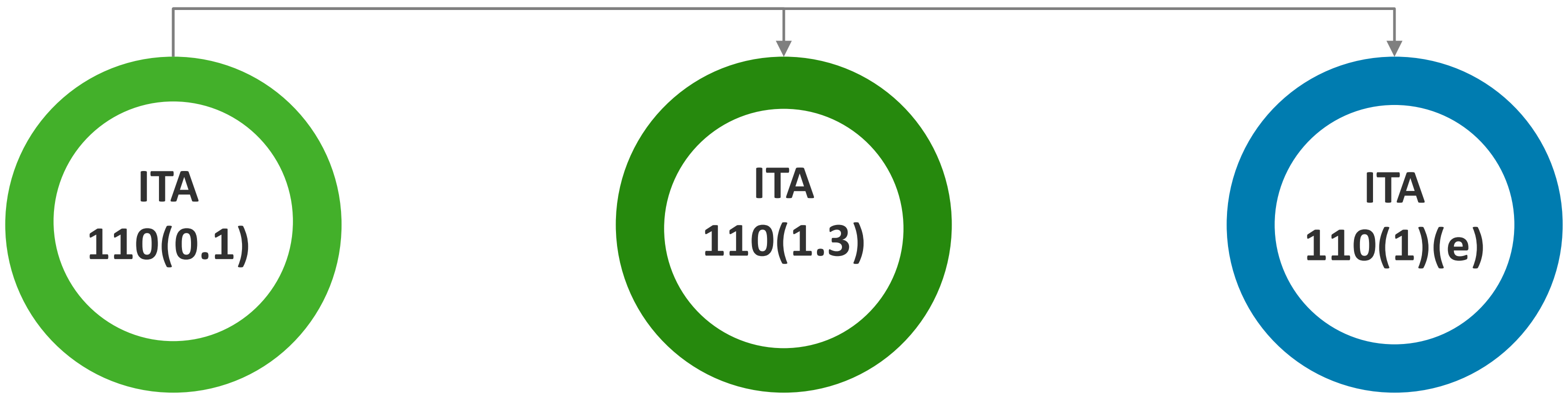
Selling restrictions
Lead to a decreased taxable fair value which becomes the cost base. Upfront taxes on the taxable fair value are due at inception.

Taxes paid at settlement/
sale are based on the capital gain (settlement value—fair value at inception). This capital gain is then taxed at half the marginal tax rate.

Corporate deductibility of non-qualified securities issued to employees

Key observations: understanding the new proposed legislation

The proposed legislation, in ITA section 110, introduces the following new concepts:



"Specified Person" Concept

Excludes CCPC and organizations with annual revenues <$500M

"Non-qualified securities" Concept

Options to acquire shares in specified person (employer or non-arm's length party)

"Employer deduction" Concept

Available for non-qualified securities

Key aspects of changes in stock option taxation

Overview of Employer deduction—ITA 110(1)(e)

What?

Stock option benefit related to **non-qualified securities** issued to **employees subject to Canadian tax**

Who?

The employer at **the time of grant** of options

Why?

Employee is not entitled to the stock option deduction for non-qualified issues

How?

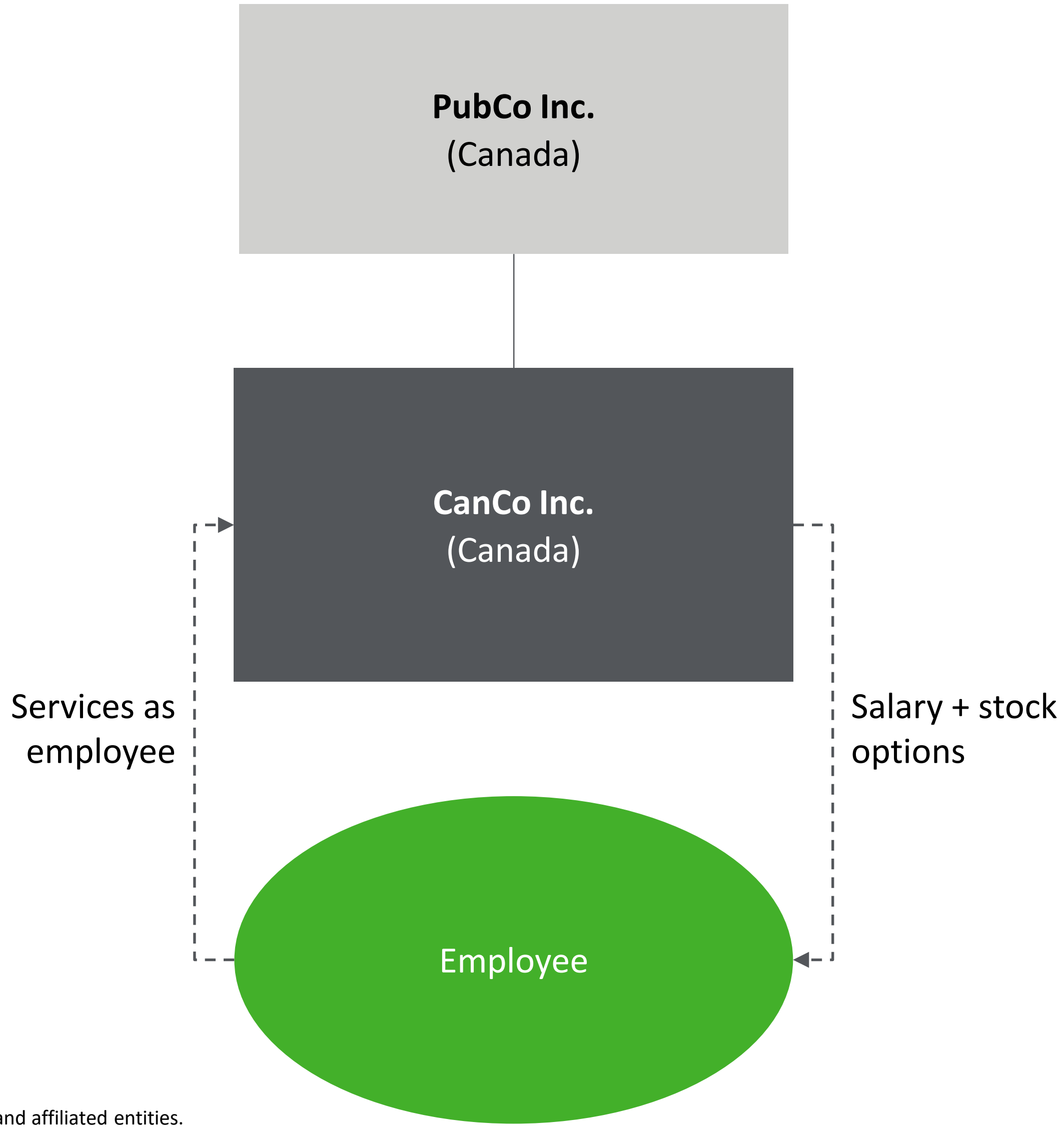
Deeming rule

Employing entity does not have to incur any outlay/expense related to the stock options

Notifications timely filed to employees and to the Minister

Corporate deductibility of non-qualified securities issued to employees

PubCo Inc. and CanCo Inc.



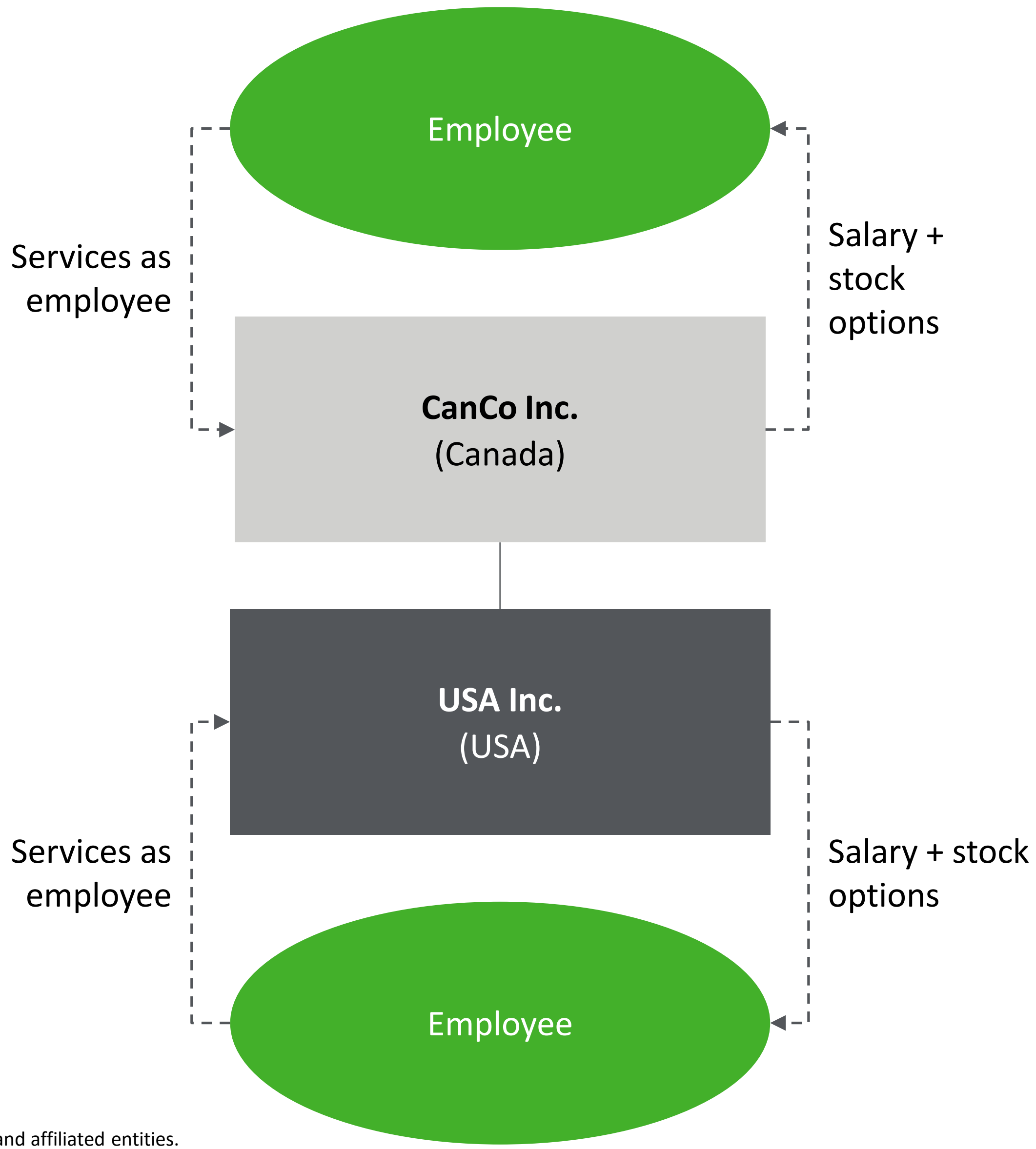
Key assumptions

- PubCo Inc. is listed on the TSX with annual revenues exceeding $500M
- CanCo Inc. is a tax resident of Canada
- CanCo Inc. employ individuals
- As part of their compensation package, these individuals are granted stock options, after July 1, 2021, to acquire shares of PubCo Inc.
- Employees of CanCo Inc. are employed and residents of Canada

- Corporate deduction available for CanCo Inc. for nonqualified securities

Corporate deductibility of non-qualified securities issued to employees

CanCo Inc. Vs. USA Inc.



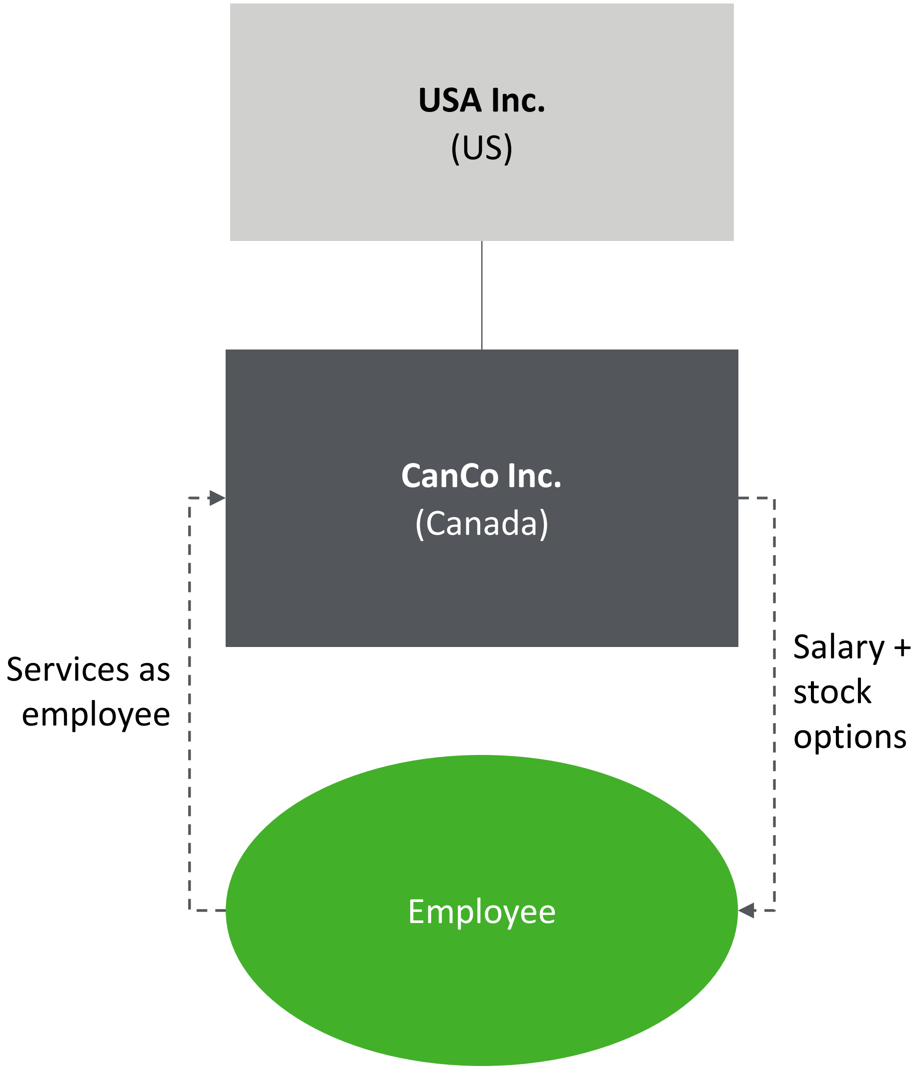
Key assumptions

- CanCo Inc. is listed on the TSX with annual revenues exceeding $500M
- USA Inc. is a tax resident of USA
- Both CanCo Inc. and US Inc. employ individuals
- As part of their compensation package, these individuals are granted stock options, after July 1, 2021, to acquire shares of CanCo Inc.
- Employees of CanCo Inc. are employed and residents of Canada
- Employees of USA Inc. are employed and residents of USA
- CanCo Inc. bears all of the costs of stock options granted to its employees, and employees of US Inc. (i.e., there is no intercompany recharge)

- Corporate deduction available for CanCo Inc. for nonqualified securities issued to its employees
- No corporate deduction in Canada for USA Inc. employees

Corporate deductibility of non-qualified securities issued to employees

Impact of the absence of an intercompany recharge agreement



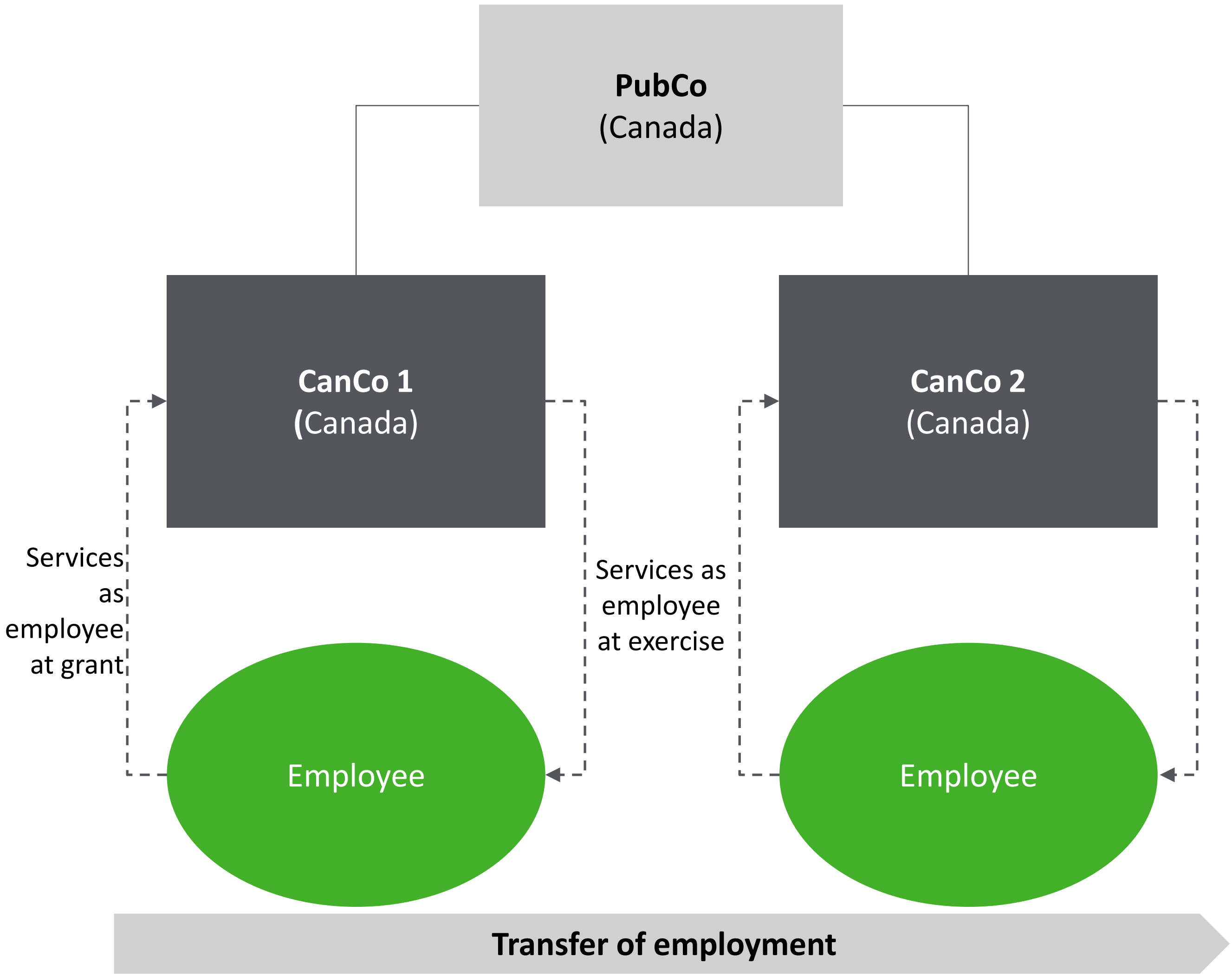
Key assumptions

- USA Inc. is listed on the NASDAQ with annual revenues exceeding $500M
- CanCo Inc. is a tax resident of Canada;
- CanCo. employ individuals that work and reside in Canada
- As part of their compensation package, these individuals are granted stock options, after July 1, 2021, to acquire shares of USA Inc
- USA Inc. bears all of the costs of stock options granted to employees of Canada Inc. (i.e., there is no intercompany recharge)

- Corporate deduction available for CanCo for nonqualified securities issued to its employees (even in the absence of a recharge agreement)
- USA Inc. would not get a corporate deduction for non-US sub employees

Corporate deductibility of non-qualified securities issued to employees

Transfer of employment contract between the grant date and exercise date



Key assumptions

- Pubco issues stock options to Employee
- At the time of grant, Employee is employed by CanCo 1
- At the time of exercise, Employee is employed by CanCo 2
- Pubco has > $500M in annual gross revenue

- Corporate deduction available for CanCo 1 for nonqualified securities issued to its employees
- No corporate deduction in CanCo 2 even if exercise occurs when employed by CanCo 2.

Accounting implications for share-based payments

Recognition and measurement – Basic principles

Share-based payments should be recognized when the goods or services are received.

Equity settled	Cash settled	With cash alternatives
Fair value at grant date (for employees) or date on which goods or service are received (for non-employees)	Fair value each balance sheet date	Equity component Cash component
No changes in fair value after initial measurement	Re - measure at fair value until exercise/settlement	**Equity component**: No changes in fair value after initial measurement **Cash component**: Re-measure at fair value until exercise/settlement.

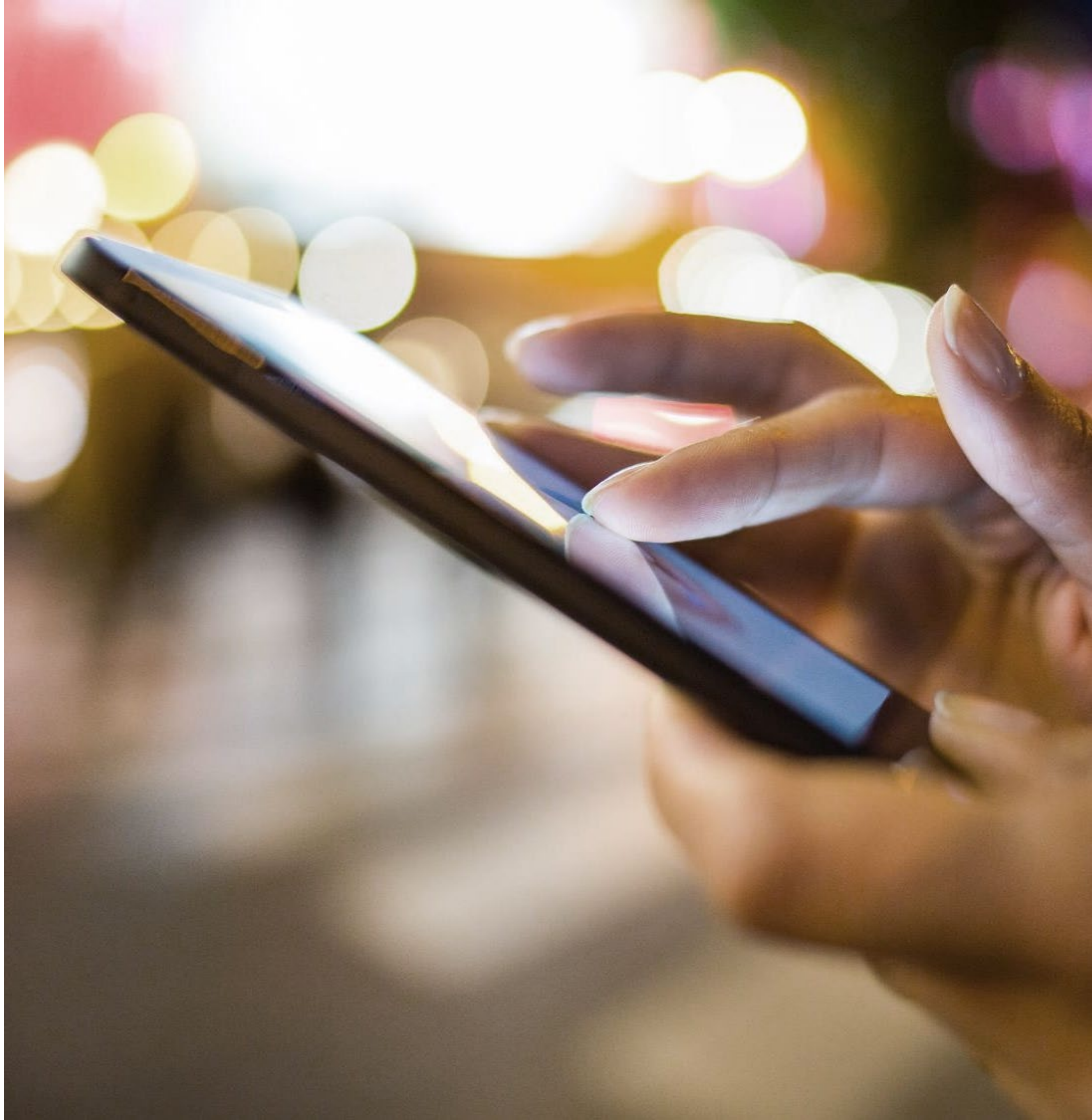
Accounting implications for share-based payments

Accounting for Income Tax Impact - Simple Example

Grant Date	Options to acquire qualified securities	Options to acquire qualified securities	Options to acquire non-qualified securities	Options to acquire non-qualified securities
	Grant date	Exercise date	Grant date	Exercise date
Compensation Expense (1)	$1,000,000	$0	$1,000,000	$0
Tax expense portion (non-cash)	$0	$0	$0	$300,000 (2)(3)
Option Gain (i.e., intrinsic value at exercise)	$0	$2,500,000	$0	$2,500,000
Corporate Tax Reduction (30% of gain)	$0	$0	$0	$750,000
Deferred Tax Asset				$750,000 (2)(3)
Portion recognized in income - see above	$0	$0		$300,000 (4)
Increase in Equity (excess tax reduction)	$0	$0		$450,000

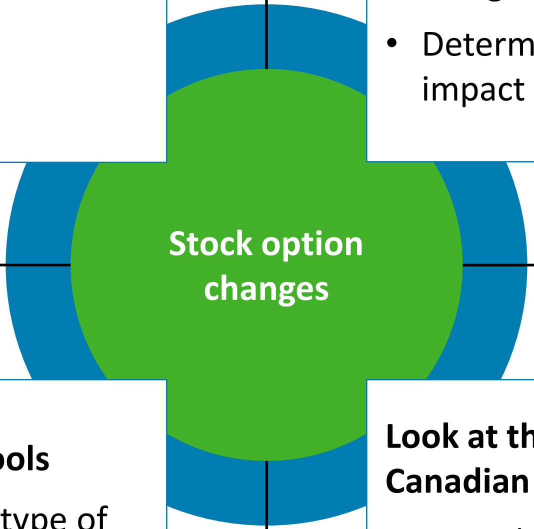
(1) Based on the fair value of the award at the grant date
(2) Benefit would be recognized over time as the option gain accrues based on the fair value of shares at the end of each period
(3) Subject to the deferred tax asset meeting the recoverability requirements based on expectation of future income
(4) The benefit recognized in income would be limited to the benefit based on the original compensation expense

Polling question #3



Where do we go next?

Organizations face a complex landscape and will need to make certain decisions on the design of their future LTIP



Assess alignment to LTIP goals

- Motivation, pay-for- performance, risk
- Flexing between pay-for- performance and overall costs
- Shifting shareholder/stakeholder perspectives

Assess the role stock options in the LTIP mix

- Re-evaluate the current LTIP mix and RSU/PSU alternatives
- Design the 200k allocation strategy
- Determine the value of the corporate tax deduction and cashflow impact

Establish internal administration processes and tracking tools

- Develop tracking mechanism for the 200k allocation and type of option grants
- Inform CRA and employees on type of option grants
- Develop internal processes for stakeholders (internal and external)

Look at the global landscape and forecast the impact on the Canadian compensation practices

- United States: ISO vs nonqualified stock options usage
- Qualified stock options may be most relevant for broad based employee plans
- Jurisdiction differences in structuring LTIP

Q&A

For additional questions,
please contact cagestax@deloitte.ca

Q&A

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Appendices

$200k limit: how it works and the impact

Numerical example—Scenario 1: 4-year ratable vesting

Key assumptions:

- **2022 Option Grant:**
  - Share price at 2022 option grant: $50/share
  - # options granted: 20,000
  - Total FMV of options at grant: $1,000,000

Key assumptions:

- **2023 Option Grant:**
  - Share price at 2023 option grant: $50/share
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  - Total FMV of options at grant: $1,000,000

	Total value vesting per calendar year					
	2022	**2023**	**2024**	**2025**	**2026**	**2027**	**Total**
Total value (2022/2023 grant)		$250k	$500k	$500k	$500k	$250k	$2M
200k allocation		($200k)	($200k)	($200k)	($200k)	($200k)	
Total value Non-qualified options		$50k	$300k	$300k	$300k	$50k	

$200k limit: how it works and the impact

Numerical example—Scenario 1: 4-year ratable vesting

Example of potential employer election regarding the 200k annual allocation:

- For years in which there is a portion of only one (1) grant that is vesting (i.e., 2023 and 2027), the employer chooses to allocate the 200k allocation to such grant.

- For years in which there is a portion of the 2022 and 2023 grant that is vesting (i.e., 2024-2026), the employer chooses to allocate the 200k allocation fully to the 2022 grant.

	Total number of options vesting per calendar year						
	2022	**2023**	**2024**	**2025**	**2026**	**2027**	**Total**
Total # Options vesting		5,000	10,000	10,000	10,000	5,000	40,000
# Qualified Options - 2022 grant		4,000	4,000	4,000	4,000	-	**16,000**
# Non-qualified Options - 2022 grant		1,000	1,000	1,000	1,000	-	4,000
# Qualified Options - 2023 grant		-	-	-	-	4,000	**4,000**
# Non-qualified Options - 2023 grant		-	5,000	5,000	5,000	1,000	16,000

$200k limit: how it works and the impact

Numerical example—Scenario 1: 4-year ratable vesting

Example of potential employer election regarding the 200k annual allocation:

- For years in which there is a portion of only one (1) grant that is vesting (i.e., 2023 and 2027), the employer chooses to allocate the 200k allocation to such grant.

- For years in which there is a portion of the 2022 and 2023 grant that is vesting (i.e., 2024-2026), the employer chooses to allocate the 200k allocation on a pro-rata basis between both grants.

	Total number of options vesting per calendar year						
	2022	**2023**	**2024**	**2025**	**2026**	**2027**	**Total**
Total # Options vesting		5,000	10,000	10,000	10,000	5,000	40,000
# Qualified Options - 2022 grant		4,000	2,000	2,000	2,000	-	**10,000**
# Non-qualified Options - 2022 grant		1,000	3,000	3,000	3,000	-	10,000
# Qualified Options - 2023 grant		-	2,000	2,000	2,000	4,000	**10,000**
# Non-qualified Options - 2023 grant		-	3,000	3,000	3,000	1,000	10,000

$200k limit: how it works and the impact

Numerical example—Scenario 1: 4-year ratable vesting

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- For years in which there is a portion of the 2022 and 2023 grant that is vesting (i.e., 2024-2026), the employer chooses to allocate fully the 200k allocation to the 2023 grant.

	Total number of options vesting per calendar year						
	2022	**2023**	**2024**	**2025**	**2026**	**2027**	**Total**
Total # Options vesting		5,000	10,000	10,000	10,000	5,000	40,000
# Qualified Options - 2022 grant		4,000	-	-	-	-	**4,000**
# Non-qualified Options - 2022 grant		1,000	5,000	5,000	5,000	-	16,000
# Qualified Options - 2023 grant		-	4,000	4,000	4,000	4,000	**16,000**
# Non-qualified Options - 2023 grant		-	1,000	1,000	1,000	1,000	4,000

$200k limit: how it works and the impact

Numerical example—Scenario 1: 4-year ratable vesting

Example of potential employer election regarding the 200k annual allocation:

- Employer chooses to designate all options (from the 2022 and 2023 grant) as non-qualified options to maximize the employer deductions non-qualified options.

	Total number of options vesting per calendar year					
	2022	**2023**	**2024**	**2025**	**2026**	**2027**	**Total**
Total # Options vesting		5,000	10,000	10,000	10,000	5,000	40,000
# Qualified Options		-	-	-	-	-	**-**
# Non-qualified Options		5,000	10,000	10,000	10,000	10,000	40,000

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