Securities Law Bulletin

AIRD & BERLIS LLP
Barristers and Solicitors

So Many Options: An Overview of Equity Compensation and Incentives

By Daniel Everall, Saam Nainifard and Timothy Jones[1]

This article examines common forms of equity compensation, specifically option plans, restricted share unit ("**RSU**") plans and deferred share unit ("**DSU**") plans. These plans use a company's equity to compensate and incentivize employees. Each type of plan involves the issuance of new shares or the payment of amount of cash equivalent to the fair market value of such shares (cash-in-lieu of shares).

These equity-based plans vary in their suitability to remunerate (*i.e. compensation for work already performed*) and to provide incentives (*i.e.* motivating future work) for consultants, employees, officers and directors (for simplicity, all of these types of grantees will be referred to in this article as "**employees**").

The attractiveness of these plans to employers depends on a number of factors, such as:

- liquidity concerns for companies with low working capital (for example, startups);
- dilution concerns;
- where an employer is a public company, or may be planning on going public, the views of corporate governance watchdogs; and
- taxes, which affect the cost of these plans to the company along with the benefit of these plans to the employee.

Options

Many employers use options to both remunerate employees and incentivize their future performance. For cash-strapped employers, in particular, the option has been a traditional way of compensating high-value employees without incurring any cash outlays.

An option (specifically, here, a "call" option) permits the holder of the option to purchase an underlying share before a future specified date (the "**expiration date**") at a currently specified price (the "strike" or "exercise" price). The realizable value to the option holder, excluding tax considerations, is the amount, if any, by which the share value (*e.g.* price) exceeds the strike price on the date the option is exercised. If the option expires "out of the money" (*i.e.* the strike price is greater than the share value at the expiration date), the option holder receives no benefit, and no share is issued. If the option is "in the money" at its expiration (*i.e.* the strike price is less than the share value at the expiration date), the option holder will likely exercise their option and realize a benefit. Of course, the option holder may exercise at any time following the option's vesting date to the expiration date in order to realize upon its value.

Incentivizing Performance through Options

Traditionally, options were viewed as a mechanism by which companies could align the interests of their employees with those of their shareholders. This is because an option derives its value from an underlying equity position in the company, and thus, intuitively, the holder of an option desires the share value of a company to appreciate, just like a shareholder would. However, this theory is not perfectly accurate, as option holders' incentives are not exactly aligned with the interests of a company's shareholders.

An example will illustrate this point best. Presume the current share value of an employer is $20 and the strike price is $10. So long as the share price stays above $10, for every dollar the share price appreciates or depreciates, both a shareholder and option holder directly gain or lose one dollar. However, if at the time of expiration the share price is worth between $0 (*e.g.* the company is bankrupt) and $10, the option holder gains nothing. Their option expires out of the money and worthless.

This payoff pattern is considered asymmetric as the option holder realizes the upside, but not all of the downside; in essence, the option holder does not bear the same capital risk of a shareholder. An option holder, therefore, will not always be incentivized to behave like a shareholder. Specifically, in a situation where an option is likely to expire worthless, the option holder has an incentive to take bigger risks than a shareholder would just for the slim chance of share appreciation (*i.e.* for out-of-the-money options, expected value is correlated with risk). This analysis, however, can become more complicated as option grants may also be subject to vesting conditions similar to those discussed below with respect to RSUs.

Regardless, companies with extremely low share value, such as a startup, may not need to worry about this disconnect between option holder and shareholder incentives. Where company shares are worth a minimal amount at the time the option is granted, the option holder's payoff path is typically quite similar to a shareholder's.

Tax Consequences of Option Compensation

Employees are taxed based on their employment income. An employee's employment income is the salary, wages and other remuneration received by the employee in the year. Furthermore, the value of any benefit received or enjoyed by the employee in the year in respect of their employment is generally required to be included in the computation of employment income for that year. This is referred to as the "receipt" principle. However, when an option is granted by an employer to an employee pursuant to an agreement to issue or deliver shares, the employee is deemed not to have received a taxable benefit in the year of grant. Instead, the employee is deemed to receive a benefit when the option is exercised and the shares are acquired or, in the case of an option granted by a corporation which, at the time of grant, qualified as a Canadian-controlled private corporation ("**CCPC**") (generally, a private corporation that is resident in Canada and not controlled by one or more non-residents or public corporations), when the optioned shares are subsequently sold. For tax purposes, the value of the benefit is the difference between the value of the shares on the date of exercise and the amount paid by the employee to acquire the shares (usually the strike or exercise price).

An employee's cost in the optioned share will generally be equal to the value of the share on the date of exercise (which equates to strike price plus the taxable benefit). If the employee sells the shares, a capital gain or loss will generally be realized. A capital gain is the excess of the proceeds of sale over the cost of the shares to the employee. Conversely, a capital loss is the excess of the cost of the shares over the proceeds of sale. The stepped-up cost base of the shares provides the employee with full recognition of amounts previously taxed as employment income, which avoids double taxation on a future sale of the shares.

An employee may deduct half of the amount of the taxable benefit in the computation of employment income if certain conditions are met. This deduction is intended to ensure that the employee's benefit is taxed at rates equivalent to capital gains rates (which is effectively taxed at half the rate of employment income). The deduction is generally available if the employee acquires ordinary common shares pursuant to the option agreement and the amount payable to acquire the shares was not less than the value of the shares at the time the option agreement was entered into. An alternative deduction is also available if the option was granted by a corporation that, at the time of grant, was a CCPC, the employee acquired the optioned shares and held them for at least two years prior to sale. In this case, the taxable benefit included in the employee's employment income in year of sale will be reduced to half. Only one of these two deductions may be claimed by an employee.

Employers are taxed on their income from a business. In computing an employer's income from a business for a taxation year, the employer may deduct expenses incurred for an income-earning purpose. This includes the salary or wages paid to an employee. However, employers cannot deduct the value of options granted or shares issued to an employee. This means that even though options have an economic cost to the corporation (the forgone cash from selling that share to an investor), that cost is not tax deductible, unlike other methods of compensating employees. Pre-revenue and early-stage startups are frequently undeterred by this, as they are not always earning enough taxable income to make the distinction relevant.

Restricted Share Units (and their cousin, Deferred Share Units)

Many employers use restricted share units to both remunerate and incentivize future performance of employees. For cash-flush employers, in particular, RSUs where the employer promises to pay the recipient the cash equivalent to the value of a certain number of shares provide the advantages of equity-based compensation, but without the dilution concerns of options.

The recipient of an RSU receives a promise by the employer to grant the recipient shares or pay the recipient the cash equivalent to the value of shares. RSUs are thus often referred to as "phantom shares." As the recipient does not actually hold or own any shares in the company, they would not be permitted to vote or be entitled to dividends. Certain plans, however, will provide for payments of additional RSUs commensurate with any dividends paid to shareholders.

An RSU is typically seen as a more effective way of remunerating employees for past service performed, as its value is not contingent on the share price going above an exercise price. Unless the employer goes bankrupt (and its shares become worthless), the recipient of an RSU can generally expect to receive a positive benefit from their grant, subject to vesting conditions discussed below.

A deferred share unit is a particular form of RSU that meets certain conditions under the *Income Tax Act* (Canada). Shares received pursuant to a DSU plan can only be realized "after the employee's death, retirement or loss of office or employment." This may therefore limit the effectiveness of DSUs as a form of compensation, especially for young employees who need access to liquid assets at the start of their lives.

Incentivizing Performance through RSUs

RSUs are generally seen as providing incentives more in line with those of company's shareholders; the benefit of an RSU is not contingent upon the employer's share price and a pre-determined strike price. However, as will be discussed below, RSUs are almost always subject to certain vesting conditions that will impact the incentives imparted upon the recipient.

Generally, large RSU grants will be subject to vesting conditions – this is to ensure the recipient does not, in effect, cut and run after the grant. If the vesting conditions are not met, the units may expire without the employee being able to claim the underlying value. A common vesting requirement is continued service with the employer or performance targets. For example, an RSU could vest as follows:

1. 25% immediately upon the grant; and
2. an additional 25% every 6 months thereafter.

These vesting conditions make the value of an RSU asymmetric, similar to an option, but instead of payoff being zero for any share value under the strike price, payoff is zero where the vesting conditions are not met. This asymmetry, though divorced from the benefits received from actual share ownership, need not create the same risk-taking incentive that arises in the option scenario. This is because the vesting conditions are fully customizable, and thus need not respond positively to risk-taking behaviour. The example illustrated above, where vesting was contingent upon length of continued employment, is a good example of this; in fact, employees approaching completion of a vesting term may actually decrease risky behaviour so as to ensure they are not fired before vesting completes. If vesting conditions are likely to be reached, an RSU holder has incentives largely similar to those of shareholders.

Tax Consequences of Restricted Share Unit Compensation

The taxation of RSUs is very technical, but, generally speaking, can be broken down into the treatment of RSUs and DSUs.

An employee who was granted an RSU by an employer is taxed in a manner similar to options on the presumption that the employee, not the employer, has the right to elect whether the RSU is settled in cash or shares (the tax consequences of the arrangement may be materially different if the employer has the right to cash-settle). In that case, the employee is deemed to receive a benefit when the shares are acquired or, in the case of RSUs granted by an employer that, at the time of grant, was a CCPC, at such time as the underlying shares are subsequently sold. The value of the benefit will be the value of the shares on the date of exercise. As with options, the employee may claim a deduction in computing their taxable income for an amount equal to 50% of the employment benefit if certain conditions are met. Furthermore, an amount equal to the full value of the benefit is included in the cost base of the shares.

If the plan involves DSUs, the employee will not be taxed on the value of any benefit until the employee actually receives the shares. Once received, however, the benefit is fully taxable as employment income, but a deduction in computing taxable income is available for an amount equal to 50% of the employment benefit if certain conditions are met.

Like options, there is no provision that allows an employer to deduct the value of the shares in the computation of its business income when an RSU or a DSU is granted to an employee or underlying shares are issued in settlement of the RSU/DSU.

Corporate Governance Constraints

If a company is private, an equity incentive plan is extremely customizable. However, when a company goes public, its host stock exchange will likely impose limitations on its plans. These limitations are usually designed to limit dilution of shareholders not eligible to participate in the plan and to limit lucrative grants to certain types of persons, such as insiders. Although these limitations are not required in the private company context, shareholders who do not directly oversee the company (with, for example, a seat on the board), may wish to include similar protections in their company's equity incentive plans.

Summary

All three types of plans have advantages and disadvantages, depending on factors including the company's cash situation, capital structure and expected growth. In any event, the potential deployment of equity incentive plans should be discussed at an early stage, and revisited frequently throughout a company's lifecycle.

If you have questions regarding this article, please contact the author or any member of the Aird & Berlis LLP Corporate Finance Group:

Lawyers:

Sherri Altshuler	416.865.3081	saltshuler@airdberlis.com
Aaron S. Bains	416.865.3084	abains@airdberlis.com
Christopher F. Berrigan	416.865.3065	cberrigan@airdberlis.com
Melanie Cole	416.865.4638	mcole@airdberlis.com
Daniel Everall	416.865.4733	deverall@airdberlis.com
Thomas A. Fenton	416.865.4631	tfenton@airdberlis.com
Tony Gioia	416.865.3403	tgioia@airdberlis.com
Jacqueline Goslett	416.865.4741	jgoslett@airdberlis.com
Richard M. Kimel	416.865.3961	rkimel@airdberlis.com
Martin E. Kovnats	416.865.3419	mkovnats@airdberlis.com
Matthew V. Liberatore	416.865.4639	mliberatore@airdberlis.com
Andrew Magnus	416.865.4744	amagnus@airdberlis.com
Jeffrey K. Merk	416.865.7768	jmerk@airdberlis.com
Anne E. Miatello	416.865.7717	amiatello@airdberlis.com
Margaret T. Nelligan	416.865.7710	mnelligan@airdberlis.com
Graham Topa	416.865.4739	gtopa@airdberlis.com
Liam Tracey-Raymont	416.865.3964	ltracey-raymont@airdberlis.com
Jennifer A. Wainwright	416.865.4632	jwainwright@airdberlis.com
Susan Wolburgh Jenah	416.865.4707	sjenah@airdberlis.com

[1]Timothy Jones is an articling student at Aird & Berlis LLP.

AIRD & BERLIS LLP
Barristers and Solicitors

Brookfield Place
181 Bay Street, Suite 1800
Toronto, Ontario, Canada
M5J 2T9
T 416.863.1500 F 416.863.1515
www.airdberlis.com

Any of the articles or papers written by our professionals can be viewed at: **www.airdberlis.com**