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The Learning Kurve

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Employee Trusts

Many small businesses would like to provide key employees with equity in the business to both attract and retain skilled workers. The most common form of equity participation is stock options issued directly to employees. A less common approach is the use of an employee trust, either in conjunction with a typical employee stock option plan, or instead of one.

In order to fully understand the benefits and methods of using an employee trust in the corporate structure, it is first necessary to provide a brief review of how stock option plans work.

Stock Options

Under a typical stock option plan, an employer provides their employee with a right to purchase a certain number of shares for a stated exercise price. Generally, the option vests over some time period, and if an employee leaves their employment with the company before the option vests, it is cancelled and returned to the option pool.

When an employee exercises an option, an employment benefit is realized, calculated as the difference between the fair market value ("FMV") of the share on the date of exercise and the exercise price. If the company issuing the option is a Canadian-controlled private corporation ("CCPC"), the employment benefit will not be added to the employee's income until the year the share is sold. For income tax purposes, if the exercise price of the option is equal to the FMV of the underlying stock at the date the option was issued, or in the case of a CCPC, if the share is held for at least two years, only half of the employment benefit will be taxable (such that the employee has capital gains like treatment on the employment benefit). The employment benefit is otherwise taxed as regular employment income.

If the option is exercised and the employee holds the shares for a while, until there is an exit, either:

1. If the shares are sold for an amount greater than the FMV on the date the options were exercised, he/she will realize a capital gain equal to the difference between the proceeds realized on the sale and the FMV of the shares on the date the option was exercised to acquire the shares. In some cases, the employee may be able to use their $750,000 lifetime capital gains exemption ("CGE") to shelter all or a portion of the realized capital gain, provided the shares qualify.
2. If the shares are sold or disposed of for an amount less than the FMV on the date of exercise, the difference will be a capital loss to the employee. This means the employee may have taxable employment benefit, a capital loss (which often cannot be applied to reduce employment income), and little or no funds with which to pay the tax liability. This was the unfortunate circumstance many high-tech employees in Ottawa found themselves in, having exercised options when the share value peaked, only to see the company's value fall to record lows, sometimes ending in bankruptcy.

Employee Trusts

There are two ways an employee trust can be used in connection with the issuance of stock options:

Options issued by a trust

A trust can hold shares in a corporation, and issue options to the employees. The trustee issues options to purchase the shares from the trust directly.

In these circumstances, the effect of issuing options from the trust is not materially different from that of a corporation issuing the options directly, and the income tax risks and rewards to the employee are as described above. These trusts are not generally used in a private company setting.

Shares issued by a trust

The second method by which a trust can be used with employee equity incentive plans is an employee trust which holds shares in the corporation. The beneficiaries of the trust are the employees, and the trustee holds the shares for the benefit of the employees, its beneficiaries.

In this scenario, the employee is deemed to have acquired the shares at the time the trust acquired the shares. As such, any employment benefit would be calculated as of the day the trust purchased the shares, and the two-year hold period commenced when the trust acquired the shares.

The benefit of using this type of employee trust is that the shares can be issued to the trust early in the company's development, when the shares do not have any real value (thus minimizing or eliminating the employment benefit attributable to the shares and taxable in the employee's hands). In addition, since the employee is deemed to acquire the trust's holding period for the shares, the employee may have a better chance of being able to use the CGE on any gain realized on the sale of qualifying shares.

The CRA has offered little guidance on the use of this type of trust. There is reason to believe that the beneficiaries of the trust could include both present and future employees such that employees who join the company at a later date can be distributed shares from the trust and realize the same benefits as an employee who has been employed since the start of the company.

The creation of an employee trust will allow management to remunerate employees via dividends from the after tax profits of the company, rather than through a salary/bonus plan. Should the shares of the company be sold, employees may be able to receive a share of the gain on sale, and will be taxed accordingly.

The allocation of shares from a trust to certain employees could be an effective motivation for some employees, although the fact that employees do not pay for these shares may be a disincentive for some.

Summary

While an employee trust may not be ideal for every company, it is an alternative worth considering. Owners/managers should discuss the costs and benefits of such a plan with their professional advisors, especially if one is already contemplating adding an employment equity incentive plan to the corporate structure.

This article has been contributed by LaBarge Weinstein LLP, A Business Law Firm www.lwlaw.com

LaBarge Weinstein

This'n That at Logan Katz

December Breakfast Seminar

We hope to see you at our breakfast seminar to be held on December 6th. In collaboration with *Laurentian Bank of Canada* and *University of Ottawa Telfer School of Management*, Logan Katz is pleased to welcome Carlos Leitao, Chief Economist and Chief Strategist of Laurentian Bank Securities who will offer an economic perspective for 2013. Book your seat now by visiting our Events page at www.logankatz.com/seminars.shtml

Logan Katz Food Drive

As the holiday season is approaching, we are reminded of those less fortunate than ourselves. The spirit of giving fills our hearts as we proudly announce the launch of our Holiday Food Drive to support the Ottawa Food Bank!

We encourage all our clients to bring in a donation of non-perishable food or household products on their next visit our office.

We thank you for your support. Together, we continue to make a difference in our community!

Stache for Cash Fundraiser — Ottawa Regional Cancer Foundation

Logan Katz's male staff participated in the annual Stache for Cash benefit to help raise funds for men's cancers and the purchase of a da Vinci Surgical System. Logan Katz raised in excess of $5,800 and was ranked second amongst the top ten fundraising teams in Ottawa. Jason Valente was ranked in the top five individual fundraisers.

Our sincerest gratitude to our clients, friends and family for their generosity and support.

October On-Line Poll

The Logan Katz October on-line poll asked "Are you following the U.S presidential campaign". Our non-scientific results were 45% YES, 36% SOMEWHAT and 18% NO. Visit our website to participate in our monthly polls.