Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Employee compensation — Deferred share units

As an employee, you may be compensated in a number of ways. Your remuneration could include salary, a bonus, and/or shares of the company you work for. This article discusses the taxation and implications of receiving deferred share units (DSUs).

What is it?

DSUs are hypothetical share units that are granted to you based on your position in the company, the length of time you have been employed by the company and/or the company's performance. These notional units fluctuate in value based on the underlying company stock but don't represent actual share ownership until you convert the units to shares at redemption time. DSUs are designed to mirror share ownership and you'll generally be granted additional DSUs equal to the value of dividends being paid on the regular shares. DSUs can only be awarded to employees of a corporation.

DSUs generally cannot be redeemed until after your retirement, termination of your employment, or death. You may be able to redeem your DSUs for either company shares or cash.

Why is it used?

Companies generally use DSUs as a form of long-term compensation. They are meant to encourage employees to consider the long-term success of the company and maximize share value over a long-time horizon. One of the drawbacks of DSUs is that they may not be viewed as an incentive if employees anticipate a significant drop in share price.

How is it taxed?

To the individual

There's no tax implication to you when you're granted DSUs. Taxation is deferred until you redeem the DSUs. At redemption, the fair market value (FMV) of the units will be taxed as employment income on your income tax return for the year the redemption takes place. The taxable benefit arising from the redemption of DSU's is not eligible for the stock option deduction.

An amount equal to the FMV of the units, net of the applicable source withholding taxes, could be paid out to you in cash or shares of the corporation. If you receive shares, any future gain or loss on the sale of those shares would generally be taxed as a capital gain or loss.

Where there is tax-deferral on the compensation you receive, you should be aware of the salary deferral arrangement (SDA) rules. The SDA rules are complex but essentially have been put in place to prevent you from deferring the receipt and taxation of compensation by having your employer defer your compensation earned in a current year to a future year. If the SDA rules are triggered, you'll have to pay tax on the compensation in the current year, even if you receive the compensation in a future year.

There is a specific exemption from the SDA rules for DSU plans. If your employer makes a payment within one year after you retire, are terminated from your employment, or your death, and this payment is based on the FMV of the company shares, the DSU plan will not be considered a SDA. This means you must redeem all of your DSUs no later than the end of the first calendar year following the year of your retirement, termination of employment, or death if you want to avoid the SDA rules.

To the company

The corporation is entitled to a deduction equal to the FMV of the units in the year it's paid out of the plan as stock payments (provided that the corporation acquires the shares on the open market) or as a cash payout. If the shares are provided to the employee from treasury in exchange for their units, no deduction is available to the corporation.

The company needs to be aware of the SDA rules and structure the DSU plan accordingly. Due to the increased Canada Revenue Agency (CRA) scrutiny of DSU plans, care should be taken when structuring such plans. The wording of DSU plans should contain a formula related to the employee's duties to determine, in advance, the number of DSUs that can be awarded. A qualified tax advisor can assist in the structuring of a DSU plan.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

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NAV0206 (09/2024)