Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Employee compensation — employee share purchase plans

As an employee, you may be compensated in a number of ways. Your remuneration may include salary, a bonus and equity-based compensation. This article discusses the features and tax implications of employee share purchase plans (ESPPs), which are one type of equity-based compensation. ESPPs are also sometimes referred to as "employee stock ownership plans" or "employee stock purchase plans."

What is it?

An ESPP is a program offered by your employer that allows you to purchase shares of the company, usually for fair market value (FMV). Purchases are made using your after-tax funds and are usually done through payroll deductions from your regular pay or at scheduled times throughout the year, as a lump-sum purchase from a single pay period.

Often, employers will offer incentives to encourage you to participate in the ESPP. Incentives may include your employer matching a certain portion of your contributions to purchase the shares. An example of matching is where you contribute to the plan based on a percentage of your pay and your employer contributes half of what you contribute. The ESPP then purchases shares for you with both your contributions and your employer's contributions. Alternatively, the plan may allow you to purchase the shares at a discount as an incentive to participate in the ESPP. That being said, this second option isn't as common in Canada because of the less favourable tax treatment (and is therefore not discussed in this article).

Once the shares are purchased, you have the right to vote the shares and receive dividends, but you may be restricted from selling, transferring, or assigning them until after the vesting period (the set period of time you need to work for your employer before you fully own the shares in the plan), which is usually about a year.

If a company's shares meet the conditions for being qualified investments in a registered plan, an ESPP may allow contributions to be directed to and shares to be purchased in a Registered Retirement Savings Plan (RRSP) or a Tax-Free Savings Account (TFSA). Keep in mind that it's your responsibility to ensure you have sufficient contribution room if you're directing your contributions to your RRSP and/or TFSA.

Why is it used?

Companies use ESPPs to give you a long-term stake in the company; this in turn allows you to experience the risks and rewards of ownership and aligns your objectives with company and shareholder objectives. For employers, the general hope is that participating in an ESPP may encourage you to consider the long-term success of the company since you stand to benefit if the value of your shares increases, as well as from annual dividends. For you as the employee, ESPPs may provide an incentive and a method to save for the future.

How is it taxed?

To the employee

Non-registered accounts

With an ESPP, you would be taxed on your contributions from payroll deductions as well as your employer matching contributions. The funds contributed to the plan by you and your employer would be treated as your taxable employment income.

Once the shares are purchased, the taxation of the shares is like any other share investment. Any dividends paid on your shares in the plan would be included in your income for the year, regardless of whether the dividends are distributed out of the plan to you in the year. In addition, any dispositions of your shares (e.g., selling, assigning, or transferring them) within the plan would be a taxable event and you would have to report a capital gain or loss, even if the funds aren't withdrawn from the plan. In determining your capital gain or loss, the adjusted cost base (ACB) of your shares will generally be the fair market value (FMV) of the shares at the time you purchased them. Keep in mind that when you purchase identical shares at different times, there is an averaging rule which requires the ACB to be averaged amongst all of the identical shares you hold in non-registered accounts at that time. Generally, this means the ACB of your shares would be the total amount paid for all of your shares divided by the total number of shares owned.

Registered accounts

Your ESPP may allow you to direct some or all of your contributions to an RRSP or TFSA account where the shares are then purchased inside your registered plan. The funds contributed to the plan by you and your employer would be treated as your employment income, which is reported to you on a T4 slip. Your employment income would generally be subject to income tax withholding at source. However, where your contributions are directed to your RRSP, your employer may not withhold income taxes at source.

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Your contribution to these registered plans will be limited by your RRSP and TFSA contribution room, respectively. A contribution receipt will be issued for any RRSP contributions made and these are deductible in calculating your taxable income.

Dividends paid on any shares held in your RRSP or TFSA will not be taxed when received in your registered plans. Also, any shares you sell inside your RRSP or TFSA are not subject to income tax at the time of disposition.

The full amount of any funds withdrawn from your RRSP is taxable in the year withdrawn and will be reported to you on a T4RSP slip. You can withdraw funds from your TFSA tax-free.

To the employer

Your employer should be able to claim a deduction for contributions to the ESPP since these amounts represent your compensation, which you directed towards purchasing company shares. However, the deduction is only available to your employer if the company shares are purchased on the open market by the trustee of the ESPP. If instead the trustee of the ESPP purchases treasury shares from the company, your employer would not be able to claim a deduction.

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