



Wealth
Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES



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Employee compensation — restricted share awards

As an employee, you may be compensated in a number of ways. Your remuneration may include salary, a bonus and equity-based compensation, for example. This article discusses the features and tax implications of restricted share awards (RSAs), which are one type of equity-based compensation. RSAs may also be known as “restricted stock awards” or “restricted shares.”

What are they?

RSAs are actual shares awarded to you by your employer, but you're restricted from transferring, selling or assigning them for a specified period of time until they vest. Vesting conditions can be based on various requirements, such as staying with the corporation for a specific period of time or the achievement of certain financial targets.

Because you own actual shares of the corporation, you generally have the right to vote the shares and receive dividends on the shares even before the vest.

You may forfeit your RSAs if you leave the company before they vest or if you or the company don't meet the conditions set out in the plan. Keep in mind that the RSA plan should also contain provisions to deal with what happens to unvested RSAs in the event of death, disability, involuntary termination or retirement.

Once the shares vest, the restrictions are removed.

Why are they used?

Companies generally use RSAs as a form of long-term compensation. RSAs allow you to experience the risks and rewards of ownership and align your objectives with company and shareholder objectives. By tying your compensation to share value and possibly other performance targets through the vesting conditions, you now have similar objectives to the company and its shareholders. If the vesting conditions are not achieved, you may forfeit the shares.

Another common purpose of using RSAs is to retain key employees. This is achieved by attaching vesting and forfeiture conditions related to your length of service or still being employed on the vesting date. For example, there may be a condition that if you leave your employer

before the vesting date of your RSA, you forfeit them. This makes leaving more costly.

How are they taxed?

To the employee

At date of grant

The value of the RSAs you receive is taxed as employment income and generally have to be included in your income when they're granted to you (subject to the exception discussed later), even though they're subject to restrictions and forfeiture prior to vesting. This is because the Canada Revenue Agency (CRA) treats RSAs as being acquired when you obtain ownership rights, such as the right to receive dividends, the right to vote the shares and the right to a return of capital if the corporation is dissolved.

The amount you include in your income is equal to the fair market value (FMV) of the shares at the time of grant. However, the FMV of the shares may be discounted to reflect the restrictions placed on them. Accordingly, the adjusted cost base (ACB, which is the cost of the shares for tax purposes) of these shares should equal the amount you include in your income. In addition, the ACB would generally have to be averaged with other identical shares that you purchase or receive.

In the case of RSAs granted for shares of a Canadian-controlled private corporation (CCPC), the income inclusion is calculated at the time the RSAs are granted, but tax is generally not payable until you dispose of the shares or are deemed to dispose of the shares. Forfeiting the shares would be treated as a disposition of the shares held under the RSA plan.

Your employer is required to withhold and remit tax when the taxable event occurs. In the case of non-CCPC shares, this would be at the date of grant. In the case of CCPC shares, this could be at the time the shares are disposed of, deemed to be disposed of or forfeited. There are various ways to deal with the withholding tax requirements. For example, your employer corporation could pay the withholding taxes and have you reimburse them. Alternatively, your employer could withhold taxes on your other cash compensation, or they could sell some of the shares to fund the withholding taxes. The method of dealing with the withholding tax requirements should be a part of the RSA plan agreement.

When it comes to dividends paid on your RSAs, even during the period before vesting, these are taxed as investment income. The dividends can be eligible, non-eligible or foreign dividends, depending on whether the corporation paying the dividends is a Canadian or foreign corporation.

The amount you include in your income is equal to the fair market value (FMV) of the shares at the time of grant.

At date of forfeiture

RSAs can be forfeited if you leave your employer before the vesting period is over or if the vesting conditions are not met. In this case, you'll realize a capital loss on the forfeited shares equal to the difference between any proceeds received from your employer, if any, and the ACB of your shares. It's important to recognize here that the capital loss cannot be used to offset the income inclusion when the RSAs were granted. This is a very harsh tax consequence, since the income inclusion at the date of grant is fully taxable whereas the capital loss at forfeiture is only 50% deductible but only against capital gains. The capital loss may offset any capital gains you realize in the year or any unused amount can be carried back three years or forward indefinitely.

In the case of RSAs for shares of a CCPC, the income inclusion calculated at the date of grant would now have to be included in your income on forfeiture, and the taxes would be due. As discussed earlier, withholding tax would also apply at this time. Keep in mind that if you held the CCPC shares for at least two years, you may be able to claim a deduction equal to 50% of the income inclusion under certain circumstances. This is beyond the scope of this article, but you should discuss it with a qualified tax advisor to determine whether the 50% deduction would be available to you.

Alternative tax treatment – RSAs held in a trust

An RSA agreement may provide for shares to be held in a trust for you until they vest. In this case, if the requirements in the Income Tax Act are met, you may be able to claim a deduction from your employment income, instead of a capital loss, if you forfeit your shares as a result of not meeting the vesting conditions.

The amount you can deduct is equal to the amount included in your income at the time of grant. In the case of CCPC shares, the amount you can deduct is equal to the amount included in your income at the time of forfeiture, minus the 50% deduction, if you're able to claim this.

At date of vesting

When your RSAs vest, the restrictions are lifted without any tax implications to you.

At date of disposition

On an eventual sale of your shares, now unrestricted, you'll realize a capital gain or loss if you held your shares as a capital asset.

In addition to recognizing a capital gain or loss on disposition, in the case of RSAs for shares of a CCPC, the income inclusion calculated at the date of grant would now have to be included in your income and the taxes would be due. The same rules as discussed in the section on forfeiting the CCPC shares, with respect to withholding and the 50% deduction, apply here as well.

To the employer

Where the shares issued to you under the RSA agreement are newly issued or from treasury, there are no tax implications to your employer corporation at the date of grant or the date of vesting. This means no deduction is available to the corporation in these circumstances.

However, the corporation may be able to claim a deduction, in the year the RSAs are granted to you, if your employer pays a broker to buy shares on the open market for you. In this case, the amount of the deduction would be equal to the price your employer paid to acquire the shares, which is their FMV.

Your employer is required to withhold and remit taxes to the CRA when the taxable event occurs — the date of grant for non-CCPC shares and the date of disposition or deemed disposition for CCPC shares.

Because of the possible negative tax consequences that employees face if RSAs are forfeited, or if the value of the shares decreases, RSAs generally only make sense if the value of the shares is very low or nominal at the time of grant. This may be true for a new business when the value of the common shares is very low, or if the restrictions on the RSAs reduce the value of the shares significantly. If the shares are held in a trust, these negative tax consequences may be mitigated.

When your RSAs vest, the restrictions are lifted without any tax implications to you.

Another negative tax consequence is the mismatch in the timing of the income inclusion and the employee's ability to fund the related tax liability by selling the shares. That being said, however, this mismatch doesn't occur in the case of RSAs for CCPC shares, so RSAs may be more appropriate for CCPCs.

How are RSAs different from RSUs?

Both types of compensation are based on the value of your employer company's stock. RSAs provide you with actual share ownership at the time of grant, while restricted share units (RSUs) are notional units linked to the value of the common shares of the company. You do not receive actual shares at the time of grant. RSUs may be settled in cash or shares, whereas RSAs are actual shares received at the time of grant. Consequently, you're generally taxed on the RSA at grant date while RSUs are generally taxed at the time of vesting.

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