Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Dann Cushing, CFA, FCSI
Portfolio Manager & Wealth Advisor
Tel: 416-842-7942
dann.cushing@rbc.com

Gregory Johnston, CFA
Associate Investment Advisor
Tel: 416-974-7576
gregory.johnston@rbc.com

Cushing Private Wealth Partners
of RBC Dominion Securities
181 Bay St, 22nd Floor
Bay-Wellington Tower
Toronto, ON M5J 2T3
cushingwm.com

Employee compensation – restricted and performance share units

As an employee, you may be compensated in a number of ways. Your remuneration could include salary, a bonus, and equity-based compensation. This article discusses the features and tax implications of restricted share units (RSUs) and performance share units (PSUs) which are a type of equity-based compensation. RSUs are also known as restricted stock units.

What are they?

RSUs and PSUs are hypothetical share units that are granted to you by your employer. They give you the right to receive, at a later date, the value of the number of notional shares of the company stock granted to you when the vesting conditions have been met. Vesting conditions are usually based on time or performance. These hypothetical units fluctuate in value based on the value of the underlying company stock but do not represent actual share ownership. Since RSUs and PSUs are meant to mirror share ownership, when dividends are paid by the company, some plans may grant additional notional units having the same value as the dividends paid.

When the units vest, you will either receive a cash payment or actual shares of the company. The value of the RSUs is calculated by multiplying the number of vested units you hold by the share price at the time of vesting. The value of the PSUs is calculated by multiplying the number of vested units by the share price at the time of vesting and by a performance multiplier. The performance multiplier is generally based on achievement against company targets.

You may forfeit your RSUs or PSUs if you leave the company before they vest or if you or the company does not meet the conditions set out in the plan. The plan should also contain provisions to deal with what happens to unvested RSUs and PSUs in the event of death, disability, involuntary termination or retirement.

Why are they used?

Companies generally use RSUs and PSUs as a form of mid-term compensation that can provide for tax deferral for up to three years if settled in cash, or longer if settled in company stock. A common purpose of using RSUs and PSUs is to foster an ownership culture and to align employee objectives with company and shareholder objectives. For example, share price and certain performance targets are important to the company and shareholders. By tying employees' compensation to share price (and certain performance targets) the employees now have similar objectives to the company and its shareholders.

Another common purpose of using RSUs and PSUs is to retain key employees. This is done by deferring some compensation and attaching vesting and forfeiture conditions. For example, if you leave your employer before the vesting date of your units, you will forfeit them. This discourages you from leaving the company before your RSUs or PSUs vest.

How are they taxed?

To the employee

At date of grant

Generally, RSU and PSU plans that are settled in cash provide for payment within three years following the end of the calendar year in which the RSUs or PSUs are granted. This timing ensures that the salary deferral arrangement (SDA) rules in the Income Tax Act do not apply. If this timing is adhered to, there are no tax implications at the time of grant.

It is possible to structure an RSU or PSU plan to pay out after the three years without triggering the SDA rules, if the plan settles by delivering newly issued or treasury shares of the company. If this is the case, and assuming the RSU or PSU plan is properly structured, there should be no tax implications at the time of grant.

At date of vesting

When your RSUs or PSUs vest, the amount you receive may be higher or lower than the value of the RSUs or PSUs at the time they were granted to you. For example, if the value of the company's shares goes down or if certain performance targets are not met, the value of the units at vesting will be less than the value at the time they were granted to you.

If the RSUs or PSUs are settled in cash and within the three-year period, you will have a full income inclusion in the year of receipt equal to the value of the RSUs or PSUs. Taxes must be withheld by your employer and remitted to the Canada Revenue Agency (CRA).

If the RSUs or PSUs are settled with company shares, you will have a full income inclusion in the year of receipt equal to the value of the RSUs or PSUs. Taxes must be withheld by your employer and remitted to CRA. If the shares used to settle the RSUs or PSUs are purchased on the open market, then the settlement must occur within the three-year period so that the SDA rules do not apply. If newly issued or treasury shares are used to settle the RSUs or PSUs then the deferral period can be longer than the three-year period.

If you receive shares, any future disposition of the shares will result in a capital gain or loss.

If you receive shares, any future disposition of the shares will result in a capital gain or loss. The adjusted cost base (ACB) of the shares should be equal to the fair market value at the time you received them. In addition, the ACB would generally have to be averaged with other identical shares that you purchase or receive.

To the employer

If the RSUs or PSUs are settled in cash, your employer corporation can claim a deduction for the total amount of cash required to be paid to you to settle the units. If the RSUs or PSUs are settled with shares of the company where your employer pays a broker to buy shares on the open market for you, your employer corporation may be able to claim a deduction for the amount paid to purchase the shares.

In most cases, if the RSUs or PSUs are settled with newly issued shares or treasury shares, no deduction is available to your employer corporation. However, in limited situations, your employer may claim a deduction for RSU or PSU plans that settle in newly issued or treasury stock. The deduction may be allowed if all of the following conditions are met:

- the employer has the right to determine whether the units will be settled in cash or previously unissued or treasury shares
- they do not commit to delivering shares at any time before settlement, and
- they actually deliver shares.

In all cases, your employer is required to withhold taxes and remit them to the CRA. Where the RSUs or PSUs are settled with shares of the company, 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 RSU or PSU plan agreement.

How are RSUs different from RSAs?

Restricted shares are sometimes called restricted share awards (RSAs). RSAs provide you with actual share ownership at the time of grant. RSUs are notional units granted to you which mirror the value of the common shares of the company, but you do not receive actual share ownership at the time of grant. RSUs may be settled with actual shares when they vest.

Since you receive actual shares with RSAs, you are taxed on the value of the RSAs at grant date. RSUs are generally taxable to you after they vest and are settled.