New Compensation Method: Employee Benefit Trust Replacing Stock Option Plans

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Nowadays, many employers are seeking out forms of compensation that will help motivate and retain key employees. More and more, employers are opting for one of a variety of company stock ownership profit-sharing plans to reach this objective. Employers who wish to implement this type of structure must ensure that the one they choose most adequately meets their objectives.

In this context, employee benefit trusts make it possible to reach objectives that are common to many employers while providing tax treatment that is often much more beneficial to employees.

Type of Profit-Sharing Plan

With this type of profit-sharing plan, employers must set up a trust and designate employees as beneficiaries. Subsequently, the trust subscribes for or purchases shares of the company. The trustees of the trust (usually the shareholders of the company) then hold these shares acquired for the employees. The deed of trust must include the terms that govern the holding of the shares by the trustees.

For instance, it is important to determine which employees will be the beneficiaries of the trust, at which point(s) in time and under which conditions the shares will be designated to the employees, and under which circumstances the company would be able to repurchase the shares. Once the trust is set up, any new employee designated as such by the company may become a beneficiary of the trust.

More Flexibility for Employers

Employee benefit trusts provide employers with many benefits. First and foremost, employers have more control with an employee benefit trust than with an employee stock option plan (ESOP). Contrary to an ESOP, with an employee benefit trust, employees do not personally hold the company's shares. Rather, the trustees are the ones holding said shares. As such, employees do not need to attend shareholders' meetings or have access to the company's financial information.

Furthermore, the fact that the company's shares are not personally held by the employees prevents problems should a misunderstanding arise with a profit-sharing employee. Furthermore, since the employees are not immediately shareholders of the company, the moment where the employees have to be part of the shareholders' agreement of the company is postponed to a later date.

This type of plan also gives employers much more flexibility in terms of selecting the employees who will become shareholders. If the deed of trust is drafted judiciously, there is no need to finalize the selection of employees who will become shareholders at the time that the trust is set up. Thus,

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the trust may continue to hold the shares of the company until such time as the employees who will become shareholders are chosen and the necessary conditions for the allotment of shares are met. It is therefore possible to postpone said selection until the sale of the company.

Benefits for Employees

Not only is an employee benefit trust beneficial to employers, but it also provides certain benefits to employees. Just like all other stock ownership profit-sharing plans, employee benefit trusts allow employees to benefit from the company's future increases in value. Although employees are not shareholders of the company from the time that the trust is set up, they will benefit from all of the capital gain accrued on the participating shares that will be allocated to them by the trust.

Moreover, for the purposes of certain provisions of the Income Tax Act (ITA), if a share in trust is held by a trustee, whether absolutely, conditionally or contingently, for an employee, the employee is deemed to have acquired the security at the time the trust began to so hold it for and on behalf of the employee. This presumption, set out in subsection 7(2) of the ITA, allows for the beginning of the computation of the two-year period following the owning of the shares, which is relevant for the employees' eligibility to the capital gains deduction as well as to the deduction in computing the taxable income provided for in paragraph 110(1)(d.1) of the ITA. An employee benefit trust therefore makes **certain tax benefits, such as the capital gains deduction, more accessible to employees**.

Lastly, an employee benefit trust provides a tax benefit to employees in cases in which the shares of the profit-sharing plan have decreased in value since they were issued. In the event that the trust disposes of the securities to the company and that the amount paid by the company to acquire, repurchase or cancel said securities does not exceed the amount that it had previously been paid, employees may deduct an amount to offset the taxed benefit, in accordance with subsection 7(1) of the ITA.

Through this tax treatment, employees avoid losing capital at the time of the disposition of the securities to the company, a loss of capital that would remain unusable until employees achieve a capital gain. This scenario may occur, in particular, when an ESOP is implemented.

Although an employee benefit trust provides many benefits to employees, this type of profit-sharing plan is more complex than traditional profit-sharing plans. Thus, in situations in which employers wish to share profits with a single employee, it may be appropriate to consider another type of profit-sharing plan.

Out team in Taxation and Labour and Employment are ready to advise you and to assist you in implementing them.

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