Unintended Canadian and U.S. tax consequences of changing compensation arrangements during the COVID-19 crisis

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As a result of liquidity and other business-related concerns resulting from the COVID-19 pandemic, many employers are considering, out of necessity, making changes to their employee compensation arrangements, including changes to the terms of existing equity awards or granting new equity awards. These changes are, in some cases, coupled with temporary reductions in employees' salaries in order to manage liquidity in response to the current prevailing circumstances.

Amending the terms of existing equity awards or granting new awards, especially when combined with alterations to current salaries, can result in adverse Canadian and U.S. tax consequences, which should be carefully considered by employers prior to implementing any of the above-described changes to compensation arrangements with employees.

For example, an employer may want to provide employees who are being terminated as a result of the pandemic with a longer time following termination of employment during which to exercise vested stock options. If these options are “incentive stock options” (ISOs) under Section 422 of the United States Internal Revenue Code (the Code), the extension of the exercise period is a modification that results in the options no longer being eligible for the favourable tax treatment for ISOs. This will be the case even if the employee does not take advantage of the extension. Instead of unilaterally providing for the extension and impacting the tax treatment of options, employers could give the affected employees the choice of accepting the extension of the term. Options will only lose their status as ISOs if the employee chooses to accept the extension of the term.

Another example of an amendment that may result in adverse tax consequences is tying the vesting of options granted in connection with a reduction in salary to a time when the company reinstates the prior
salary. If the company has the right to unilaterally reinstate the salary and a portion of the options would then be forfeited upon such reinstatement, the grant of the options may not be considered to be an “agreement to sell or issue shares” for purposes of section 7 of the Income Tax Act (Canada) (the Tax Act). Failure to comply with section 7 of the Tax Act can result in an immediate income inclusion and a tax treatment that is different from the regime afforded to regular stock options that qualify under section 7 of the Tax Act.

In addition, while it is generally possible to re-price existing out-of-the-money stock options so that the exercise price is equal to the current fair market value, the implementation of any such re-pricing should be undertaken carefully to ensure that the re-pricing does not give rise to negative tax or other unintended consequences to the employer or their employees. Option repricing is discussed in more detail here.

It should also be noted that the Canadian 2019 Federal Budget has proposed to limit the availability of the employee stock option deduction for employees of “large, long-established, mature firms.” While those measures were to apply to grant of options taking place after 2019, the Finance Minister has previously announced in December 2019 that the coming-into-force date has been postponed to a date to be announced in Budget 2020, which was to be tabled on March 30, 2020, but has been postponed given the current extraordinary circumstances. These new measures will have to be taken into account before implementing any changes to existing options and the grant of new awards.

If the equity awards are cash-settled phantom equity awards, any amendments to the terms should be reviewed to ensure they do not result in the application of the salary deferral arrangement rules or otherwise give rise to negative tax consequences for the employer and its employees. For example, many short-term phantom awards have a three-year term in order to rely on the three-year bonus exception to the salary deferral arrangement rules. Amending the terms of these awards to extend vesting or settlement could cause the award to cease to qualify for this exception and result in immediate tax consequences for the employee.

For awards that are deferred compensation subject to Section 409A of the Code, amending the terms of awards to extend the vesting or settlement could result in additional taxes and penalties for the employee.

In addition to considering the tax consequences, changes to employees’ equity and non-equity compensation arrangements can also result in employee dissatisfaction and, if such dissatisfaction is not addressed, employee claims. Employers should consider and seek advice with respect to whether such changes are permissible, taking into consideration the express and implied terms of their employment contracts. Where material adverse changes are introduced, getting consent, providing advance notice and giving consideration to the interests of employees prior to making such changes can reduce potential employment law risks, depending on the circumstances.

Also, for publicly traded companies, there may be additional considerations under securities laws and stock exchange rules that may impact the nature or timing of changes to equity compensation arrangements.

For more information, read Stock option repricing considerations in the COVID-19 Era.
Amending the terms of existing equity awards or granting new awards, especially when combined with alterations to current salaries, can result in adverse Canadian and U.S. tax consequences, which should be carefully considered by employers prior to implementing any of the above-described changes to compensation arrangements, including changes to the terms of existing equity awards or granting new equity awards.

As a result of liquidity and other business-related concerns resulting from the COVID-19 pandemic, many employers are choosing to manage liquidity in response to the current prevailing circumstances.

Another example of an amendment that may result in adverse tax consequences is tying the vesting of stock options to the executive’s commitment to remain with the company. If the option is an incentive stock option (ISO) under section 422 of the United States Internal Revenue Code (the Code), the extension of the exercise period is a modification that results in a taxable event. If these options are “incentive stock options” (ISOs) under section 422 of the United States Tax Act, failure to comply with section 7 of the Tax Act can result in an immediate income inclusion and a corresponding increase in the employee’s tax liability.

For awards that are deferred compensation subject to Section 409A of the Code, amending the terms of these awards to extend vesting or accelerating vesting could cause the award to cease to qualify for this exception and result in immediate tax consequences for the employee.

If the equity awards are cash-secured phantom equity awards, any amendments to the terms should be given the current extraordinary circumstances. These new measures will have to be taken into account before implementing any changes to existing options and the grant of new awards.

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In addition to considering the tax consequences, changes to employees’ equity and non-equity awards to extend vesting or settlement could result in additional taxes and penalties for the employee. For awards that are deferred compensation subject to Section 409A of the Code, amending the terms of these awards to extend vesting or short-term phantom awards have a three-year term in order to rely on the three-year bonus exception to the salary deferral arrangement rules. Amending the terms of these awards to extend vesting or providing for the extension of the exercise period is a modification that results in a taxable event. If the company chooses to accept the extension of the term, then the employee will lose their status as an ISO if the employee does not take advantage of the extension. Instead of unilaterally providing for the extension, the grant of the options may not be considered to be an extension of the term.

Another example of an amendment that may result in adverse tax consequences is tying the vesting of options to the employee’s continued employment. While it is generally possible to reprice existing out-of-the-money stock options so that the exercise price is equal to the current fair market value, the implementation of any such repricing should be carefully considered by employers prior to making such changes, taking into account the express and implied terms of their employment agreements. In addition, while it is generally possible to reprice existing out-of-the-money stock options so that the exercise price is equal to the current fair market value, the implementation of any such repricing should be carefully considered by employers prior to making such changes, taking into account the express and implied terms of their employment agreements.

If the equity awards are cash-seeded phantom equity awards, any amendments to the terms should be reviewed to ensure they do not result in the application of the salary deferral arrangement rules or alter options to sell or issue shares for purposes of Section 7 of the Income Tax Act (Canada). The grant of the options may not be considered to be an extension of the term if the employee does not exercise the options or take advantage of the extension. Instead of unilaterally providing for the extension, the grant of the options may not be considered to be an extension of the term if the employee does not take advantage of the extension. Instead of unilaterally providing for the extension, the grant of the options may not be considered to be an extension of the term if the employee does not take advantage of the extension.

In the COVID-19 Era, many employers are considering, out of necessity, making changes to their employee compensation arrangements during the COVID-19 crisis. These changes are, in some cases, coupled with temporary reductions in employees’ salaries in order to manage liquidity in response to the current prevailing circumstances. These changes, in some cases, coupled with temporary reductions in employees’ salaries in order to manage liquidity in response to the current prevailing circumstances.

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