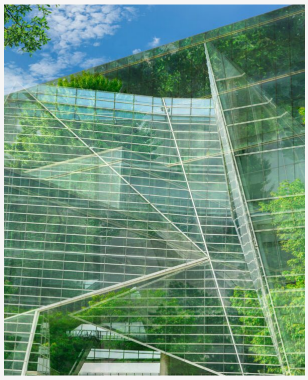
OSLER

ESG and executive compensation in Canada

JULY 6, 2021 11 MIN READ



Related Expertise

- Corporate Governance
- Executive Compensation
- Tax
- Tax Advisory Services

Authors: Dov Begun, Christopher Chen

As the momentum for environmental, social, and governance (ESG) initiatives accelerates, Canadian corporations increasingly seek deferred compensation tools that align executive priorities with ESG objectives. Well-designed tax policies on executive compensation arrangements can reinforce sustainable change, as ESG initiatives move from trend to traction. In this article, we outline this crucial conversation and add our voices to it.

We believe that the adoption of ESG objectives by the private sector will determine the pace at which these objectives are met. In a 2017 report [PDF] published by Ceres, a non-profit organization, it was noted that a formal process for managing sustainability risks would help "capitalize on the market opportunity created by tackling sustainability challenges." And yet, according to a CTV news report, a majority of shareholders at a recent shareholders' meeting of a major Canadian financial institution rejected a proposal that the company adopt broad, "company-wide, quantitative, time-bound targets for reducing greenhouse gas emissions"—despite senior management's calling climate change an "existential threat" and "the most pressing issue of our time." Although promises were made to boost sustainable financing by 2025 and reach net-zero emissions by 2050, obstacles remain to shareholders' and executives' fully embracing the integration of ESG targets into compensation metrics. Given this hesitancy, governments have an opportunity to intervene and encourage ESG participation, particularly through tax policy initiatives.

ESG impact of tax rules limiting deferral of employment income

Governments have shown increasing willingness to rely on business tax measures and income tax incentives to achieve ESG objectives and promote desired behaviour through the imposition of duties, carbon taxes, and other measures. (See Deborah L. Jarvie, "A Primer on the Federal Carbon Tax: Policy Review and Analysis," in *2018 Prairie Provinces Tax Conference*; and a 2021 UK parliamentary committee report titled "Tax After Coronavirus," which directly addresses the role of tax in promoting decarbonization.)

Canada's Income Tax Act provides certain ESG-related tax benefits, such as accelerated depreciation for zero-emission vehicles and investments in clean energy, and it allows flowthrough shares to be used by companies engaged in clean energy and conservation. The 2021 federal budget introduced (1) additional measures to encourage investment in clean technology incentives through reductions in the corporate taxes applicable to eligible zero-emission-technology manufacturing, and (2) initiatives for expanding the availability of a

OSLER

preferred capital cost allowance (CCA) regime for clean energy equipment.

In addition, portfolio managers and research analysts face growing calls from both activists and industry groups to incorporate ESG factors into their analyses and their investment decision making. Prominent in this effort is the world's largest private money manager, BlackRock. In its January 2020 shareholder annual report, BlackRock's founder, Larry Fink, called on all companies (public and private) to follow the reporting recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD) and the Sustainability Accounting Standards Board (SASB). By these organizations' count, there was a 363 percent increase in SASB disclosures, and more than 1,700 organizations expressed support for the TCFD. To further facilitate measurement, these organizations are advising governments to agree on a common set of reporting rules for sustainability in order to deter corporate issuers from shopping for jurisdictions with less stringent enforcement. In the United States, BlackRock asks companies to disclose the diversity of their workforce, including demographics such as race, gender, and ethnicity. From June 2019 to July 2020, BlackRock voted against 55 directors or director-related items on climate-related issues.

The direct integration of ESG metrics (such as emissions, diversity targets, and employee engagement, to name a few) into the design of executive compensation arrangements may be another opportunity to further emphasize sustainable change.

ESG and executive compensation

The familiar adage that "what gets measured gets managed" remains especially relevant when applied to executive compensation. Senior executives derive a significant portion of their compensation from incentive pay, with executives in large organizations earning nearly 70 percent of their total pay from annual incentive and long-term incentive (LTI) payments rather than from base salary. The metrics selected and calibrated within these incentive plans are typically linked to the business strategy approved by the board of directors. In theory, at least, businesses have the capacity to tie a significant portion of their executives' incentive payouts to ESG performance.

In practice, the implementation of ESG metrics in executive pay has been less than optimal. According to recent statistics, only 9 percent of the 2,684 companies listed in the FTSE All World Index tied executive pay to ESG in 2020. In Canada, a 2019 Compensation Governance Partners survey of proxy circulars of 196 companies in the S & P/TSX revealed that 61 percent of the companies measured sustainability metrics in their incentives. The survey also found that

- ESG metrics were significantly more prevalent in short-term incentive plans—out of 282 disclosed metrics/goals, only 9 (3 percent) were part of a long-term incentive plan;
- sustainability, when used as a weighted component, typically represented no more than 10 percent of total compensation; and
- only 1 percent of companies weighed sustainability at over 20 percent of their incentive plan payout.

Clearly, there is a disconnect between, on one hand, the inherently long-term nature of ESG goals and, on the other hand, the tendency to use ESG metrics mainly in short-term plans. From a compensation perspective, the philosophy behind incentive design is neatly summarized in the executive compensation principles of the Canadian Coalition for Good Governance (CCGG), particularly in principle 2, which focuses on pay for performance: " 'Performance' should be based on key business metrics that are aligned with corporate strategy and the period during which risks are being assumed."

It is crucial to match the performance period (and the corresponding incentive payouts) with the risk being taken, and LTIs should be aligned with long-term business objectives. But this principle begs the question: Do current tax rules (such as the "three-year rule" discussed below) allow an appropriate time period for measuring performance in improving ESG metrics, particularly given that ESG returns may take significantly longer to materialize?

Canadian tax rules provide limited scope for deferring executive compensation. These longstanding rules generally do not align with efforts to integrate ESG measures into executive compensation. Employment income is generally taxed upon receipt. Under a broad anti-deferral rule, "deferred amounts" under a salary deferral arrangement (SDA) may be taxed prior to receipt. An SDA is broadly defined to include any arrangement under which any person has a right, in a particular year, to receive an amount after the year if it is reasonable to consider that "one of the main purposes" of the right's creation or existence is to postpone tax on salary or wages for services rendered in the particular year or an earlier year.

One widely used exception to the SDA rules applies to certain time-limited bonus plans. Specifically, under subsection 248(1), a plan is not an SDA if it is a "plan or arrangement under which a taxpayer has a right to receive a bonus or similar payment in respect of services rendered by the taxpayer in a taxation year to be paid within 3 years following the end of the year" (the aforementioned "three-year rule"). A prevalent LTI vehicle is a restricted share unit (RSU), which is effectively a phantom unit tracking the underlying value of a share. Because the Canada Revenue Agency (CRA) considers RSUs to be referable to a particular bonus paid in respect of a particular year, the three-year rule requires that the RSUs referable to the particular bonus be paid out no later than December 31 of the third calendar year following the year in which the services were rendered. If, for example, a right to an amount arises in respect of a service provided by the employee in 2021, the deferred amount must be fully paid out by no later than December 31, 2024—that date being no later than the end of the third year following the year of service for which the award is made.

Although it is clear from the legislation that the three-year period must be counted from the year in which the services have been rendered by the taxpayer, the Canadian tax authorities have historically taken a restrictive view of how to determine the service year. In a recent technical interpretation (CRA document no. 2020-0864831I7, November 13, 2020), the CRA considered a plan in which the units were granted "early" in the first year. The CRA concluded that if the units have positive value at the time of grant, it is likely that they would relate to past services rendered to the company prior to the year of grant, thereby accelerating the mandatory payout date to three years after that prior year. In effect, the CRA adopts a rebuttable presumption that awards made early in the year must relate to employee service provided in the prior year. This interpretation effectively shortens the deferral period to less than three years after the year of grant.

In addition, the "three-year" exception applies only to a "bonus or similar payment"; ordinary salary, as opposed to a bonus, generally cannot be deferred. Furthermore, other types of remuneration, such as directors' fees, are not eligible for deferral under the three-year rule.

The CRA has also adopted a broad reading of the requirement in the SDA definition that "one of the main purposes" of the right is to postpone or defer tax (for example, see CRA document no. 2020-0841961I7, July 10, 2020). It should be reasonable to conclude that compensation awards that have their performance metrics tied to measurable ESG goals and that defer for periods longer than three years do not have the postponement or deferral of tax as a "main purpose," but this conclusion remains unduly uncertain. The government could clarify the situation—and thereby foster the adoption of ESG-linked compensation—through amendments or guidance.

OSLER

Suggested reforms

As explained above, current Canadian tax policies impede the effective integration of ESG objectives into executive compensation arrangements. Reforms to address this shortcoming could include (1) clarifying that arrangements to defer employment income that are linked primarily to achieving ESG objectives will generally not be considered to have tax deferral as one of the main purposes of the arrangement, and (2) adopting a more balanced approach to the application of the three-year rule in cases where arrangements have an ESG component.

A more ambitious reform would be to add a new exception to the SDA definition for compensation plans that are linked to ESG metrics. The conventional three-year deferral could be permitted to be rolled over and extended for an additional three years if predetermined ESG developments are becoming evident at the end of the initial three-year period. This would encourage a longer-term trajectory for sustainable change through executive innovation and determination without veering too far from the existing deferred compensation regime. Alternatively, the three-year deferral could simply be extended to five years in situations where the metrics of the payout are based on industry-specific sustainability objectives.

Another approach could be to focus on vesting conditions to better align ESG metrics with executive incentives. Linking the vesting conditions of performance-based LTI awards, such as stock options or performance share units, to the organization's achievement of certain measurable and relevant ESG metrics (for example, average fatality rates, employment engagement scores, and diversity targets as opposed to the more commonly seen internal rate of return [IRR] or other return metrics) may allow for the integration of ESG into executive compensation without requiring material changes to the existing deferred compensation regime.

The 2021 federal budget confirmed the coming into force of certain previously announced changes to the stock option rules. These changes, targeting the disproportionate benefit accruing to a small number of wealthy individuals, are intended to reduce the attractiveness of stock options to highly compensated individuals at large, well-established companies. In accordance with the stated public policy rationale for affording preferential tax treatment of employee stock options to support young and growing Canadian businesses, the rules were specifically drafted not to apply to Canadian-controlled private corporations or to companies with revenues under a specified threshold.

A modification to these new stock option rules, such that corporations that achieve measurable and predetermined ESG metrics would be included in the subset of corporations exempt from these rules, could be an effective method of giving both employees and executives an incentive to think creatively about maximizing their contributions to ESG.

Even without these reforms, some organizations are already committing to a change in executive behaviour, priorities, and, ultimately, corporate culture. Each of Canada's six largest banks has added ESG components to their CEOs' compensation frameworks, and each bank has committed to increasing the diversity of employees throughout its organization, from student internships to executive appointments. Practically speaking, this commitment signals to public markets and executives that the board and shareholders expect and value change.

The effectiveness of increasing the diversity of employees at the summer-student or junior-employee levels may be directly measurable in the very short term, but the limits imposed by the three-year rule are an obstacle to the implementation of effective metrics for measuring whether these initial hires increase the diversity of employees and executives in the long term. While we applaud initiatives that promote diversity and inclusion, we anticipate that sustainable change involving talent development and the retention of new hires requires more than three years to measure in terms of medium- and long-term social objectives.

Moreover, the identification of “measurable and relevant” ESG metrics for every industry is not a simple matter. That said, best practices and standards—SASB’s “materiality map,” for example, which indicates sustainability issues that are likely to “affect the financial condition or operating performance of companies within an industry”—continue to develop rapidly. These guides may provide a starting point from which material metrics for most industries can be selected for use in LTIs.

Conclusion

Achieving critical objectives that have a global and societal impact—for example, goals related to social change and climate—will require innovative approaches in every corporate boardroom. Canadians should demand that governments, too, be committed to innovation and agility in the achievement of these objectives, in order to help investors, directors, and executives clear the initial hurdles to a sustainable and equitable future. We need discussion across industry, academia, and government about how Canada’s programs, and the tax rules applicable to them, could be better designed to meet current ESG challenges and generate future opportunities.

This article was originally published in *Perspectives on Tax Law & Policy*, part of the Canadian Tax Foundation. Co-author Christopher Chen is Managing Director of Compensation Governance Partners.