Treasury, Cash Settled and Market Purchase Share Unit Plans

The structure of a share unit plan and how a share unit is settled can have a significant impact on its taxation and accounting treatment. This update:

1. Considers three alternative share unit plans that are generally used in Canada and outlines the key advantages and disadvantages of each alternative

2. Summarizes the proposed changes to the TSX Company Manual that would increase the disclosure required for treasury based share unit plans

Share Unit Primer

Share units are the right to receive either a share or the value of a share at a future date. There are three types of share units typically used in Canadian executive and director compensation programs:

- Restricted share units (RSUs)—Typically awarded to management employees (and less commonly to executives) for targeted retention. Vest based on the passage of time (e.g., 1/3 per year for 3 years, or cliff vesting at the end of a 3 year period).

- Performance share units (PSUs)—Fastest growing component of executive long term compensation. Vest based on achievement of performance targets, and typically cliff vesting at the end of 3 years.

- Deferred share units (DSUs)—Most commonly used for director compensation. For executives, often used as a vehicle to defer annual bonus. May vest immediately, but can't be redeemed until the director/executive retires. DSUs are a component of director pay at almost all large Canadian companies.

Holders of share units typically participate in dividends, usually through "reinvestment" in additional share units that vest at the same time and based on the same criteria as the initial units.

DSUs are usually settled in cash and are subject to rules under the Income Tax Act which allow a deferral until the director or executive retires, subject to the significant limitation that the DSUs cannot be redeemed until that time.

Alternatives for Settling Share Units

RSUs, PSUs and DSUs may be settled in treasury shares, cash, or shares purchased on the open market ("market purchase"); the table on the following page summarizes the key differences based on settlement method.

Key Term	Treasury	Cash	Market Purchase
Tax treatment for executive	Full value taxed at normal income tax rates when redeemed		
Tax treatment for company	Not deductible	Deductible when paid	Deductible when shares purchased
Tax deferral period	Until redeemed (no limit). Note that it is uncommon to have treasury DSU plans, as the tax rules allow for a long deferral for cash or market purchase settled DSUs	Maximum deferral 3 years after the year earned (except DSUs, which are deferred until retirement)	
Redemption date	Any time once vested (except DSUs)	Typically a fixed redemption date (maximum 3 years after awarded, except DSUs)	
Shareholder approval	Required at AGM	No shareholder approval required	
Accounting treatment	Fixed expense	Variable expense	Fixed expense

There are some significant benefits to using treasury shares to settle RSUs and PSUs:

1. The longer tax deferral allows for longer vesting periods, which can increase retention value, the ability to maintain a tax deferred investment in the company, and flexibility for executives as to when to redeem share units. This is a particularly valuable right for executives in cyclical or commodity-based businesses as it allows them to retain their share units until a reasonable point in the business cycle, rather than having a forced redemption and tax event at a pre-determined time.
2. Settling with treasury shares allows the company to fund executive compensation through shareholder dilution. This may be critical for startups or companies that don't have sufficient cash to attract and retain key talent.

However, these advantages don't come without some cost. In particular:

1. Treasury share units must be approved by shareholders at an annual general meeting
2. The company loses the tax deduction, even though executives are fully taxed at regular income tax rates

Process for Approval of a Treasury Settled Plan
The following are the usual steps to be followed for implementing a treasury settled share unit plan.

1. Design and plan text approved by the board

    a. Typically these plans allow for the award of RSUs and PSUs and provide maximum flexibility for determining performance conditions and vesting

    b. The share reserve can be a fixed percentage of shares outstanding (which requires shareholder re-approval every 3 years) or, more commonly, a fixed number of shares

    c. The number of shares reserved should be sufficient to allow for 3 years of awards, or more typically, 5 years

2. Decide whether to engage with ISS to have them model their vote recommendation under the new ISS Equity Plan Scorecard (click here to read Meridian's client alert on ISS policy changes for 2016) or to instead engage directly with shareholders.

3. Provide the draft plan text and draft proxy circular disclosure to the TSX for pre-clearance. The TSX has some specific requirements in the TSX Company Manual, which the plan text and disclosure must comply with. In addition, the TSX will review the disclosure to ensure that it aligns with the provisions of the plan text.

Proposed Changes to TSX Company Manual
On May 26, 2016, the TSX released proposed changes to the disclosure requirements for security based compensation arrangements (which include treasury settled share-based and option plans). The public comment period ended on June 27, 2016.

The proposed changes generally increase disclosure and, in some respects, simplify required disclosure. The key changes include the following:

— There is a distinction between disclosure required when shareholder approval of a plan (or amendments) is sought versus routine annual disclosure, with less disclosure required on an annual basis

— Disclosure of the number of outstanding awards continues to be required and, where an award has a multiplier (typical of PSUs), the number must be determined using the *maximum* multiplier

— The annual "burn rate" (the number of awards (net of cancellations) in the most recent fiscal year, divided by the total number of issued and outstanding shares) must be disclosed

— More specific disclosure is required about default vesting provisions, with a specific indication of whether vesting is time or performance based

— Amendments made in the most recent year and which do not require security holder approval must be disclosed

— The issuer must post a publically accessible copy of its plan text (and related documents) on its website

— Disclosure is now required as at the end of the most recently completed fiscal year, which simplifies the current requirement which requires disclosure as at the date of the proxy circular

Note that disclosure of "other key terms" is now required only when approval is being sought for a plan or amendments to a plan.

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