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Newsletter

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Key employees as shareholders? Yes, but…

As an entrepreneur, you may be thinking of offering certain key employees the opportunity to become shareholders to reward their loyalty and motivate their performance. You are also aware that by making employees shareholders, they are likely to feel and be perceived as more invested in and committed to the business. This could be rather appealing to a potential buyer.

Corporate and tax laws set out a number of methods by which a private corporation can issue and sell shares to one or more employees. This newsletter will discuss several of these methods. Other incentive plans, such as stock option plans and employee trusts, to name a few, will be discussed in a future newsletter.

Issuance of non-participating shares

If you are interested in issuing shares to a key employee and want to allow the employee the opportunity to optimize remuneration and income tax treatment, you could choose to issue “non-participating shares with discretionary dividends”. Issuing such shares can also be an interesting option for employees who do not have the financial means to purchase shares that are currently in circulation.

The issuance of non-participating shares with discretionary dividends effectively enhances an employee’s performance bonus. On a strategic level, you are also sending the employee a vote of confidence that will be appreciated.

Such shares would be non-voting and non-participating in the growth of the corporation. The Board of Directors would maintain the discretion to declare dividends in the amount and proportion that it sees fit, without having to worry about the order of priority of distribution of dividends to other shareholders. The issuance of these shares would, however, require a preliminary reorganization of the share capital to "freeze" the value of the existing shares, after which non-participating shares would be issued to the employees for a nominal amount. Although additional costs may be incurred in doing so, we strongly recommend that this freeze be done carefully and be backed up by a valuation that will stand up to a tax audit. Issuing even non-participating shares without a “freeze” can lead to tax assessments, justified or not, creating a capital gain or a taxable benefit for the selected employees. Bear in mind, it is usually more costly to challenge a tax assessment than to simply submit your valuation report and request that the file be closed.

Sale of outstanding shares or issuance of new growth shares

Another option to allow your employees to become shareholders is to issue common shares which participate in the future growth of the corporation. This can be done in various ways:

❖ Direct sale to employees

If the employees have the required funds to acquire shares at current market value, they could purchase them directly from the present shareholders. In this case, the employees would have to finance the purchase price using their personal, after tax, funds. An existing shareholder who sells common shares could, subject to certain conditions, shelter the capital gain with an exemption of up to a maximum of $800,000.

❖ Sale to an employee-owned corporation

Employees may wish to finance the purchase by using funds from the business. In such a case, an employee could incorporate a corporation (“EmployeeCo”) to purchase the shares held by the selling shareholder and, following the acquisition, the business would transfer cash to EmployeeCo either by way of a redemption of shares or tax-free dividends. EmployeeCo would, in turn, pay the selling shareholder.

This type of transaction provides leverage to employees while allowing the selling shareholder to benefit from his or her capital gains exemption. Although this may be interesting to both employees and selling shareholders from a tax and business standpoint, this plan has a number of tax traps and requires careful review by a tax advisor prior to implementation.

❖ Financing through a "key man" freeze

Another method quite often used is by way of a "key man" or estate freeze. The common shares of the existing shareholders would be exchanged for non-participating preferred shares, after which new common shares would be issued to each of the shareholders and selected employees for a nominal amount, in the desired proportions.

It would then be possible, by way of an agreement, to establish a schedule that would govern either the transfer of the preferred shares to the employees or EmployeeCos, or governing the redemption of the preferred shares by the corporation from the selling shareholder. Using this method, the selling shareholder could extract the whole or a part of the value of the business prior to the freeze.

❖ Shares held in an RRSP

The last method by which shares could be issued to employees that we will discuss in this newsletter is for an employee to purchase shares through an RRSP. The benefits associated with doing so are considerable for employees and include the ability to receive dividend income in an RRSP account on a tax-free basis. These types of transactions, however, are complex in the case of private companies with few shareholders as several conditions apply, notably with regards to the percentage of ownership and cost of investment. Obtaining a legal opinion confirming the possibility of using this method is recommended, should this method be offered to your employees.

Have a master plan

The issuance of shares to employees is a strategic step in the life of a business and, as such, must be well thought out and executed in a manner that takes into consideration continuing operations, as well as the future growth of the corporation. Issuing shares to employees should not be considered as letting go of the reins given that the entrepreneur remains in control. Rather, doing so should be considered a strategic decision by which the commitment of employees to the business could be strengthened while simultaneously rewarding employees for past service.

In this newsletter we have examined a number of methods that are commonly used by private corporations to issue shares to their employees. However, remember that there are many methods and options that can be implemented and even combined in order to meet your specific needs. As a final note, keep in mind that tax planning should always be a secondary factor in making any business decisions, and that any tax planning work should be done prudently.

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