Employment & Benefits - Canada

Show me the money – cash incentive plans

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Introduction

When a business comes to Canada, sooner or later it will likely offer cash incentive payments to some employees resident in Canada. Employees will not expect cash incentive payments to be taxable before they are paid, which can happen if incentive arrangements are not structured with care.

The basic concepts of salary deferral and constructive receipt may be familiar, but the specific Canadian tax provisions differ from those of other countries. Due to a dearth of case law and the desire to avoid surprises for employees, reliance tends to be placed on the published practices of the Canada Revenue Agency (CRA), Canada's federal income tax collection agency.

Generally, an employee is taxed on a payment from the employer in the year it is received. However, an amount may be taxable earlier when:

- it is paid – at the employee's direction or with his or her agreement – to another person for the benefit of the employee or that other person; or
- it is credited to the employee's account, set apart for the employee or made available to the employee without restriction concerning its use (ie, constructive receipt).

Salary deferral arrangement

An amount may also be taxable before it is received if the employee is entitled to an amount in the future under a salary deferral arrangement. An incentive arrangement should be a salary deferral arrangement only if it is reasonable to consider that one of its main purposes is to postpone tax, but the CRA interprets the definition broadly and most employers do not wish to risk a challenge. An arrangement subject to one or more conditions is still a salary deferral arrangement unless there is a substantial risk that a condition will not be satisfied. Generally, a requirement to remain with the employer for a specified period is not considered to create a substantial risk. A bonus based on the increase in value of an underlying phantom share after the date of award will not generally be considered by the CRA to be a salary deferral arrangement.

A number of specific types of plan are excluded from the definition of a 'salary deferral arrangement' (eg, registered pension plans and deferred profit sharing plans), and there is a three-year exclusion on which employers often rely.

Cash incentive plans

The general options for Canadian cash incentive plans include the following:

- Short term – a bonus may be paid in light of performance in the preceding year, subject to required withholdings. The employee is taxed on the bonus in the year that it is paid, while the employer may deduct the bonus in calculating taxable income for the prior year if the bonus is paid within 180 days of the employer's year end and other appropriate steps are taken.
- Mid-term – a bonus may be awarded that is payable, subject to required withholdings, within three years of the end of the year in which the employee rendered services in respect of which the bonus was awarded. For example, a bonus awarded in March 2015 for performance in 2014 must be paid by December 31 2017. If it is clear that the bonus is not paid in respect of services rendered prior to the year of the award being made, then the bonus must be paid within three years of the end of the year of award. The employee will be taxed in the year that the bonus is received and the employer may deduct the payment in the same year. Payment of a bonus may be deferred longer if either payment:

- is subject to one or more conditions that create a substantial risk of forfeiture (although that may not be certain without obtaining an advance tax ruling); or
- is determined by the increase in value of an underlying phantom share after the award date.

- Long term – deferred share units may be awarded where all amounts will be received after death or termination of employment and the amounts depend on the fair market value of shares of the employer or a related company around the time of payment. Again, the payment will be taxed when made and the employer may deduct the payment in the same year. Registered pension plans and supplementary pension plans can also provide long-term elements of compensation.

Comment

Other types of cash plan may be useful in particular circumstances. Another set of tax rules applies if the employer or a related company agrees to sell or issue shares to the employees. Experienced advisers can help to design a structure that fits particular needs.

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