5 Variable Pay Traps to Avoid

Corporations under pressure to cut payroll usually respond with layoffs. But there may be more imaginative alternatives. One is to pay employees smaller salaries with the promise of additional compensation if the company does well. Generally used in good times to recruit and retain top talent, variable pay schemes can also be an effective way to hang onto key personnel who might otherwise be targeted for layoffs or straight pay cuts. But implementing variable pay schemes is tricky. Much of the challenge falls squarely on the shoulders of payroll. Here's how to avoid 5 common mistakes in administering variable pay arrangements.

Defining Our Scope

There's an almost infinite variety of variable pay plans. This article is limited to a particular scheme, one in which compensation is tied to a company's financial performance or value. More precisely, we'll focus on schemes where employees get a one-time pay increase over fixed salary when the company meets certain financial targets. There are four common mechanisms:

Bonuses that are tied to product or company revenues. Example: ABC Company promises to pay product manager Jenny Ray Shinn an additional 5% of her salary 6 months after a new product launch if at least 10,000 customers buy the product.

Profit sharing plans in which employees can earn a share of the company's net profits in addition to salary. Unlike bonuses, which are based on salary, additional payments are based on company profits. Example: Each year, Jenny gets 2% of the profits attributed to the product she developed.

Stock options that let employees of publicly-traded companies buy shares of company stock at a fixed price called the "exercise price." If shares increase in price, the employee benefits. Example: ABC grants Jenny the right to buy 1,000 shares of company stock at $50 per share, the market value of the stock on the date the option is granted. ABC's stock price rises to $100. Jenny exercises her option and pays $50,000 for stock worth $100,000. She then sells the shares on the open market and earns a $50,000 profit.

Discount stock purchase plans that let employees buy company stock at a discount. Typically, a portion of the employee's fixed compensation is used to buy company shares at less than fair market value. Example: Jenny lets ABC withhold 5% from each paycheque. Twice a year, ABC uses the money to buy stock for Jenny at a 10% discount.

What the Law Requires

Variable pay arrangements are subject to the same laws as payment of fixed salary, including:

- Human rights laws. Variable pay plans can't be based on discriminatory grounds such as the employee's race, age, gender, religion, disability and other protected personal characteristics;
- Employment standards. Assuming the employee is covered by the ESA, variable pay must be properly factored into calculations of her overtime and wages in lieu of notice; and
- Income tax, EI and CPP. Variable pay may be subject to income tax, CPP and EI withholding and reporting by the employer.

Actually applying the laws to variable pay arrangements is often difficult, particularly when calculating income tax withholdings, CPP deductions and EI premiums. "The almost infinite variety of variable pay arrangements makes it all but impossible to establish blanket rules," explains Ontario payroll consultant Alan McEwen. But some guidance exists. Although it doesn't provide all the answers and hasn't been updated for 2009, the best place for payroll managers to look for guidance is in CRA T4001 (Employer's Guide) and CRA T4130 (Taxable Benefit Guide).

Avoid 5 Traps

Based on CRA guidance, court cases and the advice of payroll experts, the *Insider* has unearthed 5 common traps that employers fall into when processing payroll under variable pay plans.

Trap # 1: Changing Variable Pay without Employees' Consent

Pitfall: Whether set out in an employment contract, collective agreement or company policy, employers must honour the terms of variable pay arrangements unless the employee agrees otherwise. Unilateral changes can lead to liability including for "constructive dismissal"—a form of wrongful dismissal where an employer doesn't actually tell an employee that he's fired but changes his job terms so substantially and unfavourably that it forces him to leave. Because it goes to the very heart of the employment relationship, changing the terms of compensation is the kind of practice that can lead to constructive dismissal claims—even if the change affects only the variable pay part of the compensation arrangement.

Example: Each year, an Alberta galvanizing company pays a portion of company profits to employees, in addition to regular wages. One year, without warning, the company decided to issue company shares instead of cash bonuses. The company claims it can make unilateral changes because the profit-sharing plan is a company policy rather than a term of an employment contract. But the court disagrees and orders the employer to pay profits in cash to each employee. Switching from cash bonuses to stock shares substantially changed the essential terms of employment and amounted to constructive dismissal, the court ruled [*Carabine v. Daam Galvanizing*, 2000 ABPC 56 (April 18, 2000)].

Solution: Changing the terms of variable pay arrangements isn't illegal, even if the changes are unfavorable to employees. What you <u>can't</u> do is make those changes unilaterally. Thus, in finding the company liable for constructive dismissal, the court in *Carabine* said the employer should have communicated the changes to employees and gotten their input in restructuring the plan.

However, you don't have to offer new employees who haven't yet signed an employment agreement the same exact terms that apply to current employees who are under contract. New employees start with a clean slate and you're free to negotiate any variable pay arrangement you want. Of course, payroll ultimately has to process all the agreements. And the more variable pay arrangements you make, the more burden it places on payroll.

Trap # 2: Incorrectly Applying CPP Exemption to Bonuses

Pitfall: To calculate the CPP premium amount to deduct from a pay cheque, you normally subtract a portion of the basic CPP exemption ($3,500 per year in 2013) for each pay period and multiply the remainder by the CPP rate (4.95%). But what if the employee receives not just his normal paycheque but a separate bonus cheque during the pay period? Some employers subtract the basic CPP exemption from *both* cheques. This is wrong and results in a CPP premium underpayment that employees must account for at the end of the year. The employer will also receive a Pensionable and Insurable Earnings Review (PIER) report for the deficiency.

<u>Example</u>: D. Ducts Ltd. pays a group of employees $5,000 per month in fixed compensation. The payroll department deducts CPP contributions using the basic exemption for that pay period from each paycheque. In March, June, September and December, the company hits revenue targets and, consequently, pays each employee a quarterly bonus equal to 3% of salary. The payroll department mistakenly deducts CPP contributions from each bonus cheque using the same basic exemption it applied to the employee's regular earnings, resulting in a $14 underpayment per bonus cheque, per employee, as shown in the following chart.

	What ABC Did		**What ABC Should Have Done**	
	Monthly Base	Quarterly Bonus	Monthly Base	Quarterly Bonus
Pay	$ 5,000	$ 1,800	$ 5,000	$ 1,800
Less Basic Exemption ($3,500 ÷ 12)	– $ 292	– $ 292	– $ 292	– $ 0
Contribution Base	$ 4,708	$ 1,508	$ 4,708	$ 1,800

CPP Contribution (Contribution Base x 4.95%)	$ 233	$ 75	$ 233	$ 89
CPP Contribution Underpayment: $14 per bonus check per employee				

Solution: Although the CRA guides don't spell it out, under Section 21 of the *Canada Pension Plan*, you shouldn't apply the CPP exemption against a bonus because it's not a regular paycheque. Exception: Employers in Québec must apply the QPP exemption to each pay period, even if the only thing paid is a bonus. In other words, under federal rules, the CPP exemption doesn't get applied if the only payment the employee receives in the payment period is a bonus; but it does apply if Québec is the province of employment.

Trap # 3: Treating All Profit-Sharing Distributions the Same for Tax Purposes

Pitfall: Many variable pay arrangements involve distribution of a share of company profits. Taxation of distributions varies, depending on the type of plan. CRA distinguishes among four types of plans:

- Cash or current distribution profit-sharing plans, in which the employer distributes cash or shares of stock as additional compensation to employees;
- Employee profit-sharing plans, where profits accumulate in a trust fund along with interest;
- Deferred profit-sharing plans, which also accumulate in a trust fund and are distributed after the year in which they are earned; and
- Registered profit sharing pension plans, which also accumulate in a trust fund and are distributed after retirement.

Since there are so many types of profit-sharing plans, it's easy to confuse them and report income tax withholdings at the wrong time, or not at all.

Example: Profitshare Ltd. provides semi-annual cash distributions to all employees based on a percentage of company profits. It puts an additional percentage of profits into a fund for executive managers in which these employees may also make contributions. Profitshare's payroll department properly withholds income tax from the cash distributions as it pays them. But instead of treating the executive manager's fund as an employee profit sharing plan, it misclassifies it as a deferred profit sharing plan. Result: Allocations are never reported on a T4PS slip.

Solution: Be careful when characterizing profit-sharing plans for tax purposes. If you're in doubt, review Section 5.15 of CRA's Digest of Benefit Entitlement Principles and Sections 144 and 147 of the *Income Tax Act*. Follow the chart below to determine when to withhold income tax on distributions or report allocations.

Type of Plan	Subject to Income Tax
Cash or Current Distribution Profit Sharing Plan	When paid
Employee Profit Sharing Plan	Once each year (plus tax on interest)
Deferred Profit Sharing Plan	Only when received by employee

Registered Profit Sharing Pension Plan	Only when received by employee

Trap # 4: Subjecting Stock Purchases to Double Tax

Pitfall: Another common mistake occurs when employers offer shares at a discount (that is, below fair market value) through an employee stock purchase plan (ESPP). Tax on these payments is separated into 2 amounts:

- The difference between the purchase price and the fair market value of the stock. This is the employee benefit and is subject to income tax.
- The difference between the fair market value and the selling price. This amount is taxed only as a capital gain or loss.

But employees may not know how the tax rules work; and they get no notification from their employers. This ignorance may come home to roost when employees sell their shares and pay a capital gains tax. If they don't use the right numbers to calculate their capital gain, they could be subject to double tax, which diminishes the value of their variable pay benefit.

<u>Example</u>: Decadent Corp. offers shares to John at 10% below the closing price on the day of purchase. On June 1, Decadent's stock closes at $100. John buys 100 shares through Decadent's ESPP at $90 each. Decadent must include $1,000 ($10 per share x 100 shares) in John's taxable income and withhold income tax on this amount immediately. If John later sells the stock for $150 per share, he should pay a capital gains tax only on $50 per share. Not realizing this, John pays a capital gains tax on $60 per share based on the $150 selling price less the $90 purchase price.

Solution: If employees are getting ESPP distributions, provide a clear explanation of the amount that's taxable as an employment benefit. Tell them the fair market value of the stock purchased via your ESPP as of the date of purchase and explain that they should only pay a capital gains tax on the difference between that value and the price they ultimately sell their shares for. This will keep employees from being double-taxed on the capital gain.

***Insider* Says:** In a Canadian Controlled Private Corporation (CCPC), a special type of private corporation that's not controlled by a public or foreign corporation, the employee benefit usually isn't taxed until the employee sells his shares.

Trap # 5: Repricing Stock Options

Pitfall: Remember how not too long ago, it was axiomatic that stock values always increased and that stock options would eventually end up in the money? Thus, granting options enabled companies to pay big bonuses financed not by corporate coffers but growth in share value. Of course, everything went sour when stock values started to decline. Suddenly, employees found themselves holding options that were "underwater."

<u>Example</u>: Three years ago, Joe received the option to purchase 1,000 shares of company stock at the current market price of $50 per share. A year later, the stock was worth $80 per share. If Joe had exercised his options then, he would have made a cool $30,000. But he didn't. And now that stock is trading for a measly $20 per share. So, Joe's option is worthless and will remain so until the

company’s shares recover and become worth more than $50. Of course, there’s no guarantee that will ever happen, especially in this economic climate.

That’s why there are a lot of angry executives out there. Many are asking their employers to lower the options’ exercise price to make them valuable again. But most experts agree that this is a bad idea:

- Repricing stock options alienates existing shareholders, who are expected to weather out the storm and wait for the value of their shares to increase again;
- In most cases, repricing stock options requires board and shareholder approval, and you have to disclose the modification to regulatory authorities; and
- Employees may lose the stock option deduction and pay full-tax on the options when they’re exercised.

Solution: Don’t re-price your stock options. If you have to do something, consider repurchasing them or granting restricted share units (RSUs), which are exchangeable for shares after they have vested.

Conclusion

With so many types of variable pay, taking the appropriate deductions and withholdings can be confusing. Hopefully, this article will help you avoid some of the more common mistakes employers that make when calculating withholdings and deductions or modifying variable pay programs.