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Building a Solid Foundation – Knowing Your Options When it's Time to Issue Shares

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Once your startup begins to see success, discussions often turn to shares - namely, the amount that should be issued and who should gain equity in your company. Cassels has partnered with Zeifmans, a full-service tax, accounting and business consulting firm, to author this guide to help your startup with considerations around issuing shares and creating a solid share structure.

You and a friend have a brilliant idea for a company. You pool your savings to personally fund the initial research and development and operational activities, and create an innovative startup. To build your future equity in your startup, you should reach out to your legal and business advisors to discuss issuing shares through a shareholders agreement. Here's what you should know before making any decisions.

A Tax Perspective

To Incorporate or Not?

Before making any equity decisions, it's important to know how your taxes will be impacted by incorporating. If your business is earning income as a Canadian Controlled Private Corporation (CCPC), you'll pay about 13% tax on your first $500,000 net profits, after which you'll be taxed at the general rate of 26.5%. Incorporating will allow you to defer taxes in order to reinvest your startup's profits without having to pay personal taxes, which can be higher than 50%.

If you and your friend decide to reinvest all of your earned income back into the business, then as incorporated entrepreneurs, you'll have more in after-tax funds available for your startup than if you hadn't incorporated.

Shares or Options as a Company Perk

Shares or stock options to acquire shares are often used as a way to incentivize and retain employees when a startup can't afford to pay high salaries yet. Be aware though, you cannot issue equity for services that have not been rendered. The timing and quantum of the taxable amount of stock option benefit depends on several factors.

In a well-structured plan, equity can actually be more tax efficient than a regular salary since employees benefit from Canada's capital gain tax treatment when selling stocks. A CCPC's employee generally pays tax only on the 50% of the total benefit amount and only at the time when the employee actually sells the shares acquired through the plan.

A Legal Perspective

Understanding your Shareholders Agreement

When issuing shares, an important step for a startup is to create a shareholders agreement. This agreement will act as a contract establishing rights and obligations for the shareholders, and the powers and duties of the Board of Directors.

Typically, shareholder agreements:

- Lay out how shares are issued, sold and transferred
- Establish the Board composition and duties
- Establish fundamental decision making powers
- Formulate exit mechanics (i.e., buy/sell options, rights of first refusal, right of first offer, tag along and drag along provisions)
- Determine what happens if a management shareholder dies or becomes disabled or if a shareholder that is an employee

resigns or is terminated etc.
- Provide for a pre-emptive right (also known as an anti-dilution right)
- Include a valuation procedure that ties in with certain exit mechanics
- Set-out a dispute resolution procedure (which could be mediation or arbitration instead of the court system)

While some agreements are long and complex, a guiding principle is to strive for **good governance**. A way to achieve this is to elect an experienced and diverse Board of Directors rather than trying to account for every possible scenario in the agreement. This way, your company can confidently handle issues, even if they were omitted from the agreement. We highly recommend your legal team handle the agreement, as it will serve as the foundation of your company – and a well thought out agreement at the start will avoid larger issues down the road.

Creating a Share Structure and Splitting up the Pie

While some founders choose an equal split of equity, others take several factors into account – such as the time and capital put into the company by each individual and the anticipated go forward duties of the founders. If one founder contributed a greater capital investment, completed more work, developed the IP and/or is responsible for a greater share of the work going forward, you may agree on an unequal split.

These decisions have lasting long-term effects on your partnership and must be made carefully. If one founder takes offense to an uneven split, then consider including operating metrics or milestones that could provide a founder an opportunity to earn additional equity down the line.

Common Shares

The law provides that where a company has only one class of shares, the shares will include the right to vote and receive the remaining property of the company upon dissolution. These features are typically included in a company's voting common shares which are issued to its founders.

Some companies choose to also create a class of non-voting common shares early on that are issued to employees or are created as part of a stock option plan and are issued when an employee exercises its stock options.

Why you Need a Vesting Schedule

Most founders are familiar with tying the issuance of stock options to employees, contractors or advisors with time based or milestone based vesting schedules. A frequently used vesting schedule includes a cliff (i.e., 1 year) and then monthly or quarterly vesting over a period of time thereafter (i.e. 36-48 months).

A less familiar concept is tying a similar time-based vesting schedule to shares issued to founders. This is an important concept because it is not unusual for a co-founder to resign, stop producing or have a falling out with the other co-founders. Without an ability to call or repurchase that co-founder's shares, the company could be stuck in expensive litigation.

What About Intellectual Property?

In some cases, founders will have intellectual property (like patents, trademarks and trade secrets) that have real value and need to be transferred into the newly formed corporation. Section 85 of the *Income Tax Act* provides for rollover (or tax deferral) treatment where property is transferred for shares. We recommend working with your tax advisor to assess whether a tax deferred transfer is available.

The Final Word

Creating a share structure and an employee incentive plan is an important process that will affect your company's ability to grow and retain employees. Founders need to carefully decide who to accept as shareholders and what rights and responsibilities will go into the company's shareholders agreement.

> For a tax perspective, contact Zeifmans here, or reach out directly to Ahmad Aslam, Partner at Zeifmans, at aa@zeifmans.ca

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This publication is a general summary of the law. It does not replace legal advice tailored to your specific circumstances.