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Tax Policy Branch
Department of Finance Canada
90 Elgin Street
Ottawa, Ontario
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Dear Sir or Madam,

**Consultation on stock options – Deloitte's comments**

We are writing to provide our comments on the proposed changes to the tax treatment of employee stock options as outlined in the June 17, 2019 Ways and Means Motion.

We appreciate the fact that the Government has released these proposals in the form of a consultation. We believe that this approach – which affords stakeholders the opportunity to provide input based on their experience and practical insights – will foster a greater understanding of the issues being addressed and will ultimately help to develop tax policy that will build a stronger, more competitive Canadian economy.

Generally, however, we question whether the Government should proceed with the proposed legislation. Instead, we recommend that the Government conduct a comprehensive review of the Canadian tax regime. The issue of stock options could be one of the many issues addressed as part of the comprehensive review.

In the event that this draft legislation proceeds, we would like to offer our observations and recommendations for the proposals below. We begin with some general relevant Canadian tax policy comments and follow with some recommendations specific to the employee stock option proposals.

You will note that our comments below do not recommend specific definitions for the terms start-up, emerging and scale-up companies. We think that these concepts are inherently subjective and, as such, trying to define them in tax legislation will lead to increased complexity and uncertainty. We are equally concerned about arbitrarily defining these terms with objective criteria. The proposals already exclude Canadian-controlled private corporations (CCPCs) and propose to further carve out start-up, emerging and scale-up companies. As a result, it is not clear to us that any additional revenue to be gained from these additional carve-outs would warrant the increased uncertainty. We think that the

proposed approach should be reconsidered as part of the comprehensive review we are recommending above.

**1. Impact on Canadian competitiveness**

In our December 10, 2018 pre-budget submission[1] to the Minister of Finance, we outlined a number of measures to help improve Canada's productivity and competiveness. In particular, a key focus must be attracting and retaining top talent individuals.

***Tax rates***

One of areas that we discuss is Canada's personal tax rates. Canada's top personal tax rate of 54 percent is high relative to that of the G7 average of 49 percent and the Organisation for Economic Co-operation and Development (OECD) average of 42 percent. In addition, the income threshold at which Canada's top rate applies (approximately $200,000) is relatively low in comparison to many countries.

Under U.S. Tax Reform, among other changes, the top federal personal income tax rate was reduced from 39.6 percent to 37 percent. The income threshold at which this rate applies was increased to US$500,000 (US$600,000 in the case of married couples filing jointly). While the overall top rate varies by state, the average top rate in the United States is 46 percent. In addition, the current preferential rates on both capital gains and qualified dividends remain unchanged. As a result of U.S. Tax Reform, Canada's competiveness with the United States in this area was further diminished.

This may discourage immigration to Canada and make it much more expensive for Canadian businesses to recruit and retain top talent, as tax is one of the factors that will be taken into account in establishing competitive remuneration. This could also impede transfers to Canada within multinational organizations by making Canada a less attractive destination for business due to the cost of having to gross-up employee compensation to reflect the higher income tax cost in Canada. To improve Canada's competiveness in this area, we have recommended coordinating with the provinces to reduce the top rate to 50 percent and/or consider increasing the threshold at which the top rate is reached.

We are concerned that the stock option proposals will further diminish Canada's competiveness in this area.

***Attracting talent***

Employee stock options have traditionally been used to achieve a variety of business objectives. Among other things, they act as:

- a recruitment tool in a competitive market;
- a motivator to employee performance;
- a means of retaining mobile talent; and
- a cost-effective compensation strategy for businesses with a need or desire to conserve cash.

The historical policy reasons for tax preferential treatment has been to assist with competitiveness issues, to quell the "brain drain" and to assist all businesses with their ability to attract skilled labour while maintaining working capital. Stock options provide a significant incentive to employees to contribute in the growth of the employer business and thereby contribute to the overall wealth of the Canadian economy. These proposals may

[1] https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/tax/ca-en-tax-pre-budget-policy-recommendations-AODA.pdf

hinder the ability for employers to attract and retain top talent with an attractive compensation package which includes a stock option plan.

As previously noted, we do not believe that reconsidering the tax treatment of stock options in isolation is warranted. It is our view that this should be folded into a comprehensive review of Canada's tax regime with a view towards improving Canada's overall competiveness.

**2. Areas of uncertainty in the proposals**

The income tax laws around stock options have seen quite a few changes every few years. The proposed rules. if enacted in their current state, would increase the uncertainty around the practical implications and increase the cost of compliance for businesses and for the public administration. Some practical concerns should be clarified so that Canadian businesses are able to implement the law as intended.

***Definition of "vesting year"***

The Ways and Means Motion[2] provides the definition of "vesting year" as follows:

> ***vesting year***, of a security to be acquired under an agreement, means
>
> (a) if the agreement specifies the calendar year in which the taxpayer's right to acquire the security first becomes exercisable (otherwise than as a consequence of an event that is not reasonably foreseeable at the time the agreement is entered into), that calendar year; and
>
> (b) in any other case, the first calendar year in which the right to acquire the security can reasonably be expected to be exercised.

The Explanatory Notes further provide that where the agreement does not specify the calendar year in which the individual's right to acquire the security first becomes exercisable, the vesting year will be the *first calendar year in which the right to acquire the security can* ***reasonably be expected*** *to be exercised.*

There are practical challenges with determining the vesting year at the time a specified person has agreed to sell or issue a security to an individual under the agreement, as it requires substantiating the vesting year based on reasonableness test. It is unclear, for example, how this reasonable expectation would be interpreted in the case of options with performance vesting or accelerated vesting upon a liquidity event, change of control or other event. Our recommendation is to determine the vesting year based on the year the security is actually acquired to remove such practical challenges. This would be in line with the U.S. rules for the determination of the US$100,000 Incentive Stock Options limit.

***Ordering of acquisition of securities***

New proposed subsection 110(1.41) of the Income Tax Act (the Act) provides an ordering rule for the purpose of determining whether a security acquired on the exercise of an employee stock option agreement is a non-qualified security.

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[2] Notice of Ways and Means Motion to amend the Income Tax Act released on June 17, 2019.

As the Explanatory Notes indicate:

> This subsection is relevant where an employee exercises a right to acquire some, but not all, of the securities that the employee could acquire under one or more stock option agreements and the securities acquired could be either non-qualified securities or securities that are not non-qualified securities (in this note referred to as "qualified securities"). This may be the case where, for example, the employee has a number of identical options or one agreement that could result in the acquisition of qualified securities or non-qualified securities.
>
> Under this subsection, the taxpayer is considered to acquire qualified securities first, before acquiring any non-qualified securities.

This is a welcome clarification that qualified securities would first be considered to be acquired. However, stock option grants could have different fair market values and the ordering rule would limit the discretion of the individual to choose the stock options which maximize the benefit (and associated preferential treatment). We would recommend that taxpayers be given the option to elect out of the default ordering rules if a different ordering is preferable.

**3. Administrative and compliance considerations**

***Non-qualified security designation***

The Ways and Means Motion provides as follows in subsection 110(1.4):

> If a particular specified person agrees, at any time, to sell or issue one or more securities of the particular specified person (or of another specified person with which the particular specified person does not deal at arm's length) to an employee of the particular specified person and the particular specified person designates one or more securities to be sold or issued under the agreement as non-qualified securities in the agreement, those securities are deemed to be non-qualified securities for the purposes of this section.

Further, new subsection 110(1.9) of the Act provides notification obligations in respect of agreements to sell or issue non-qualified securities.

If a security is deemed to be a non-qualified security under subsection 110(1.31), the employer must notify the employee in writing that the security is a non-qualified security on the day that the agreement is entered into. This condition is perhaps not necessary for securities that are deemed to be non-qualified securities under subsection 110(1.4) because the designation as non-qualified securities in accordance with that subsection is made under an agreement to which the employee is a party. On that basis, we recommend that the requirement to notify the employee be removed.

We would like to add that while these rules are similar to the U.S. rules which permit an employer to designate options as being non-qualified stock options, the complexity of these rules may lead to errors by individuals on their personal tax returns where they have exercised a mix of qualified and non-qualified stock options in a given year. Further, from the Canada Revenue Agency's perspective, this may be difficult to review unless changes to the reporting on a T4 slip are accurately made by the employer.

In all cases, the proposed changes impose a new requirement for employers (and employees) to accurately track qualified and non-qualified options, which will add complexity and increase their administrative burden. This situation will be even more complex for former CCPCs or for employers which may no longer be exempt from the stock option limitations (for example, if they no longer meet the prescribed conditions under the definition of a "specific person" under paragraph 110(0.1)(b)).

* * * * * *

We hope that our comments and recommendations are helpful in your consideration of these proposals. We would be pleased to meet with you or other officials to discuss our submission. Deloitte is committed to making a significant contribution to help shape Canada's tax policy and its application to the future of our country.

Yours very truly,

Deloitte LLP

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