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The Joint Committee on Taxation of
The Canadian Bar Association
and
Chartered Professional Accountants of Canada

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May 14, 2019

Ted Cook
Director General
Tax Legislation Division
Tax Policy Branch, Department of Finance
90 Elgin Street, Ottawa, ON K1A 0G5

Dear Mr. Cook:

Subject: Employee Stock Option Changes Announced in 2019 Federal Budget

In the 2019 federal budget, the Government announced its intent to move forward with implementing legislation that would limit the availability of the so-called "employee stock option deduction". The statement in the budget described the overall policy direction the Government intends to implement, but was not accompanied by any details or proposed legislation. Given the absence of such details, it is not possible for us to provide comprehensive comments. However, we believe it would be productive to highlight issues that have been raised by taxpayers and members of the tax community, which are summarized in the attached submission.

Members of the Joint Committee and others in the tax community participated in the discussion concerning this submission and contributed to its preparation, including:

- Marlene Cepparo – KPMG Canada
- Ian Crosbie – Davies Ward Phillips & Vineberg
- Ken Griffin – PwC Canada
- Dean Kraus – Stikeman Elliott
- Angelo Nikolakakis – EY Law LLP
- Michael Saxe – MNP LLP
- Anthony Strawson – Felesky Flynn LLP
- Jeffrey Trossman – Blake, Cassels & Graydon LLP
- Kim G C Moody – Moodys Gartner Tax Law

We trust that you will find our submission helpful and we would be pleased to discuss it at your convenience.

Yours very truly,

Ken Griffin
Chair, Taxation Committee
Chartered Professional Accountants of Canada

Jeffrey Trossman
Chair, Taxation Section
Canadian Bar Association

Cc: Brian Ernewein, Assistant Deputy Minister, Tax Legislation Division, Tax Policy Branch, Finance Canada
Trevor McGowan, Senior Director, Tax Legislation Division, Tax Policy Branch, Finance Canada

Employee Stock Options

In Budget 2019, the Government announced its intent to move forward with implementing legislation that would limit the availability of the so-called "employee stock option deduction". More specifically, while acknowledging that employee stock options "are an alternative compensation method used by businesses to increase employee engagement, and promote entrepreneurship and growth",[1] Budget 2019 states that "the Government will move toward aligning Canada's employee stock option tax treatment with that of the United States by applying a $200,000 annual cap on employee stock option grants (based on the fair market value of the underlying shares) that may receive tax-preferred treatment for employees of large, long-established, mature firms."[2] Importantly, Budget 2019 indicates that employee stock option benefits for employees of "start-ups and rapidly growing Canadian businesses" would remain "uncapped" so that "start-ups and emerging Canadian businesses" will retain the ability to use employee stock options as an effective tool to attract and reward employees and accelerate their growth.[3] In part, this distinction in treatment is said to be justified on the basis that certain companies "do not have significant profits and may have challenges with cash flow".[4]

While Budget 2019 does not contain any proposed legislation to implement these proposals, it does indicate that "further details" will be released before the summer of 2019 and that "[a]ny changes would apply on a go-forward basis only and would not apply to employee stock options granted prior to the announcement of legislative proposals to implement any new regime."[5]

The statement in Budget 2019 described the overall policy direction the Government intends to implement, but was not accompanied by any details or any proposed legislation. Given the absence of such details, it is impossible for us to provide comprehensive comments. However, we believe it would be productive to highlight some general questions and concerns that have been raised by members of the tax community and by taxpayers with respect to the proposed measures.

1. *Coming-Into-Force and Future Consultation*

We understand that the details of the stock option proposals will be released before the summer of 2019 and that the new rules will apply only to stock options granted after the announcement of legislative proposals to implement any new regime.

In our view, this timing raises a number of meaningful concerns for interested stakeholders. Corporations (and, in particular, publicly listed corporations) put significant time and energy, on a periodic basis, into evaluating the appropriate level and mix of employee compensation, including the portion of overall employee compensation that will ultimately be reflected in the form of stock options and similar forms of performance-based compensation. This compensation determination process is frequently a lengthy one and often involves a long lead time from the time that overall compensation decisions are made until stock options are ultimately granted.

In setting compensation, and in any negotiations between current and prospective employees and their employer, both the employer and the employees will take into account the impact of taxation in negotiating or

[1] Budget 2019, p. 203.
[2] Budget 2019, p. 204.
[3] Budget 2019, p. 204.
[4] Budget 2019, p. 203.
[5] Budget 2019, p. 204.

setting the level and mix of compensation. We believe it is important that the parties' reasonable expectations regarding the tax treatment of options should be respected. In light of this, we are of the view that both employees and employers should be provided with a reasonable notice period between the release of implementing legislation and the date the measures come into effect. We would suggest that a reasonable coming-into-force provision would be for the new rules to apply only to options granted at least 6 months after the date of release of implementing legislation.

We also believe that, given the centrality of stock options to many employees and employers, there should be a reasonable period of consultation with stakeholders in order to enable Finance to properly assess the impact of the proposals, and to take any potentially unforeseen consequences into account in drafting the legislation. Thus, to be clear, we recommend that this consultation process should proceed through a sequence that includes, first, the release of further details in relation to the conceptual approach to be taken with respect to drawing the relevant lines between affected and unaffected employees and employers (i.e., between "large, long-established, mature firms" and "start-ups and rapidly growing Canadian businesses", etc.). Second, and still as part of the consultation process, we would envision the release of draft legislative proposals, open for comment for at least one month. Finally, we would envision the eventual announcement of implementing legislation, which reflects this consultation process, and which is intended to be tabled in Parliament. It would be this announcement that would then start the clock of the transition period, assuming the implementing legislation is ultimately enacted. This approach should minimize the period of uncertainty for employees and employers.[6]

2. Limiting Proposals to Large, Long-Established, Mature Firms and Legislative Certainty

As a technical matter, it is not clear how the new restrictive proposals will be drafted so that they are limited only to employees of "large, long-established, mature firms" while at the same time ensuring that the current legislative approach to the taxation of employee stock options is preserved for "start-ups and rapidly growing Canadian businesses". We do not at this time have any specific suggestions as to how this line could be drawn as a conceptual or legislative drafting matter. Indeed, we believe that this will be a difficult line to draw. We also believe it is important that such legislative line-drawing (i) should have a clear and rational connection to the stated policy objectives of the proposals (i.e., should avoid unintuitive, arbitrary and unstable factors and distinctions), and (ii) should also be clearly and readily understandable and usable by taxpayers and tax authorities without creating a material level of uncertainty. In particular, it will be important that employees and employers be able to determine with a reasonable level of confidence whether the proposed limitations will be applicable before any stock options are granted in any given taxation year. This is important as a matter of fairness toward employees and also in light of the fact that employers will need to be able to confidently determine the correct amount to be withheld on account of the optionholder's tax. In brief, all parties need to clearly and easily understand which side of the line their situation falls on.

It is also unclear to us at this point whether Finance is contemplating only a single, perhaps multifaceted, category of protected businesses, versus multiple categories. The references to "start-ups" and "long-established" suggest factors having to do with time and age, while the reference to "rapidly growing Canadian businesses" suggests a more functional approach that is not limited by age. Obviously, "long-established"

[6] In contrast, given the upcoming election, if the clock were to start with the release of "further details" or even a subsequent release of draft legislative proposals (particularly if released before the election), there could be a fairly extended period of uncertainty that could affect the legitimate interests of employees and employers with respect to the compensation determination process.

businesses sometimes undergo transformative changes to their orientation and focus, developing new products or services with tremendous growth potential. Sometimes also an emerging business may be housed within a more diversified group of businesses that may include some more mature elements, or may be acquired into such a group. It is not at all clear how such groups would be addressed. The industry sector within which a particular business may be competing may also be relevant either directly or indirectly. For example, businesses that are competing within sectors that involve a high degree of research and development may also "not have significant profits and may have challenges with cash flow" regardless of their ages. In those contexts, the impact of changing the current regime would increase the taxation of employees without providing an effective (or as effective) deduction to the employers, thereby resulting in a form of tax windfall to government and inevitably diverting available cash flow away from research and development, which could have adverse long-term consequences.

As indicated above, employees need to understand how they will be taxed on future option benefits before they are awarded stock options, as the manner of taxation may impact their reasonable compensation expectations. Similarly, employers must also know with a high level of certainty whether any stock options benefits that are conferred on their employees are clearly subject to the restrictions as the employers may be required to make the applicable withholdings from employee stock option benefits. Any uncertainty with respect to these definitional elements of the proposed changes will result in more disputes between taxpayers and the CRA and will simply discourage the use of stock options as employee compensation, even by firms that, from a policy perspective, are intended to be protected from the application of the new restrictions.

3. Transitional Rules and Ordering

Any legislation to implement the proposed changes will need to include an approach to deal with transitional circumstances. In particular, one would expect the status of a corporation could change from "large and mature" to "rapidly growing" or vice-versa, depending on the underlying factual circumstances, and an approach will be needed to ensure that there will be certainty as to whether any stock options granted before and after such a change in status are appropriately treated under the rules. It is suggested that, like the current approach to stock options in the CCPC context, the imposition of the proposed stock option restrictions should look at the status of the corporation at the time the relevant stock options are granted and the tax treatment of the optionholder should be unaffected by any changes in status of the option grantor (or option exchanges) that occur after the time that the relevant options are granted.

In addition, a methodology will be needed for distinguishing between options that are within the $200,000 annual cap and those that are not in circumstances where only a portion of an employee's options are exercised. For instance, in the case of the example contained in Budget 2019, where in a particular taxation year Henry receives options to acquire 100,000 common shares at $50 per share (the fair market value of the shares on the date the options are granted), what if subsequent to the time of grant Henry only exercises options to acquire 4,000 common shares? As he is only entitled to the current beneficial tax treatment in respect of 4,000 of the 100,000 shares underlying his options granted in a particular year, will this favourable tax treatment apply to the first 4,000 shares acquired pursuant to his options or will some other approach be used? A workable and reasonable mechanism needs to be developed to address this and similar questions.

4. Deductibility by Employer

We understand from the examples contained in Budget 2019 with respect to the proposed stock option restrictions that the issuer of the options will be entitled to a corporate-level deduction for any stock option benefits conferred on employees to the extent that such stock option benefit is subject to the proposed restrictions and is fully taxed in the hands of the optionholder as a result. We believe the intent is for this deduction to be available any time an option is exercised and the 50% deduction in computing taxable income is unavailable as a result of the new measure, but this should be clarified. It is clear that changes will need to be made to the Act to achieve this result. In order to avoid disputes, the legislation should very clearly (i) provide a codified deduction for the stock option benefit, (ii) provide that the deduction is available notwithstanding other provisions of the Act, including in particular, paragraph 7(3)(b) and section 143.3, and (iii) apply equally irrespective of whether the option is exercised physically or cashed out. The provisions of subsection 110(1.1) should be carefully examined in the context of the proposed introduction of a codified corporate deduction to ensure these provisions remain appropriate.

In addition, an approach that favours equity and neutrality would provide the same deduction to employers that grant forms of performance-based compensation that are similar to stock options, such as so-called "phantom stock options", "performance share units" and "deferred share units", etc., regardless of whether such compensation is ultimately paid in cash or in kind. In brief, full deductibility to the employer should always be available to the employer if there is full taxation to the employee, regardless of the form of the compensation.

5. Applicability to CCPCs

It is not clear from the Budget 2019 commentary whether the proposed $200,000 restriction is confined to claims for deductions under paragraph 110(1)(d) in respect of stock option benefits or whether it would also apply to claims under 110(1)(d.1) in respect of a benefit that relates to shares of, or rights to acquire shares of, a CCPC. Presumably at least part of the underlying rationale for the existing distinct treatment of CCPC options is a general lack of liquidity coupled with significant valuation uncertainty, which would seem to support excluding CCPC options from the new restrictions, particularly in light of the $200,000 "bright line" cap being contemplated. This should be considered and clarified before the details of the proposal are released.

6. Prescribed Share Rules in Regulation 6204

An important aspect of the application of the employee stock option rules (where the rules in paragraph 110(1)(d.1) do not apply) is that the shares in respect of which the options have been granted must be prescribed shares at certain relevant times. The requirements for prescribed share status are set out in Regulation 6204. As detailed in our prior submission to the Department of Finance dated November 15, 2016 there are a number of significant difficulties with the application of Regulation 6204 in the context of market transactions that do not engage any of the concerns at which the prescribed share regulations are understood to be directed. In our view, where Finance is considering recasting the employee stock option rules in the manner outlined in Budget 2019, it would be appropriate also to rectify the existing regulatory framework to better align it with its intended purpose. To undertake a significant alteration to the employee stock option rules without addressing these shortcomings would be unfortunate, as the natural time to revisit technical issues is in the context of a broader review. We would be pleased to provide examples of problems arising under the current regulations and work with you to address these problems without undermining the purpose of the prescribed share framework.