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October 7, 2019

The Honourable William Francis Morneau, P.C., M.P.
Minister of Finance
90 Elgin Street
Ottawa, Ontario K1A 0G5
Canada

Via Electronic Mail

Re: Proposed Changes to the Tax Treatment of Employee Stock Options

Dear Minister Morneau:

On behalf of Tax Executives Institute Inc. ("TEI"), I am pleased to accept the Department of Finance's invitation to submit comments with respect to the income tax legislative proposals on employee stock options that were released for public consultation on June 17, 2019. If enacted, these proposals would fundamentally alter the Canadian tax treatment of employee stock options—for employees and employers alike—and impose new tax reporting and compliance requirements on many Canadian businesses. TEI's comments address significant competitiveness and efficiency concerns raised by the proposed changes and provide recommendations for mitigating them to the mutual benefit of government, employers, and employees.

About TEI

TEI was founded in 1944 to serve the professional needs of in-house tax professionals. Today, the organization has 57 chapters across North and South America, Europe, and Asia, including four chapters in Canada. Our approximately 7,000 members represent 2,800 of the largest companies in the world, many of which either are resident or do business in Canada. Over 15 percent of TEI's membership comprises tax professionals who are employed by Canadian businesses from all regions and a variety of industries. TEI members are responsible for administering the tax affairs of their employers and must contend daily with provisions of the tax law relating to the operation of business enterprises. These comments reflect the views of TEI as a whole but, more particularly, those of our Canadian constituency.

As the preeminent association of in-house tax professionals worldwide, TEI is dedicated to the development of sound tax policy, uniform and equitable enforcement of tax laws, and minimization of administration and compliance costs to the mutual benefit of government and taxpayers. TEI is committed to fostering a tax system that works—one that is administrable and consistent with the principle of voluntary compliance. The diversity, professional training, and global viewpoints of our members enable TEI to bring a balanced and practical perspective to the issues raised herein.

Discussion

Employee stock options, which grant employees the right to acquire shares of their employer's stock in the future at a fixed price, are a common feature of many companies' employee compensation plans. Compensatory stock option plans are used not only to remunerate corporate executives but also to attract and retain talent at all levels, in all sectors. TEI members and the companies they support have traditionally favoured stock options as a method to align the long-term goals and interests of employees to those of the employer. The long-term vesting periods of employee stock options motivate employees to stay with a company for longer periods of time and take a stronger interest in the company's long-term success. Moreover, employee stock options are important in compensating dynamic and entrepreneurial employees. They provide such employees with incentives directly related to their ability to increase productivity, competitiveness, and growth of their company.[1]

To support these aims, the federal Income Tax Act (the "Act")[2] has long provided employee stock options with preferential individual income tax treatment in the form of a stock option deduction. Under current law, when an employee acquires a share under an employee stock option agreement, the difference between the fair market value of the share at the time the option is exercised and the amount paid by the employee to acquire the share is treated as a taxable employment benefit ("employee stock option benefit"). A stock option deduction equal to 50 percent of the employee stock option benefit is available to the employee, resulting in the employee stock option benefit effectively being taxed at the same rate as capital gains.[3] No corporate income tax deduction is currently available with respect to an employee stock option benefit.

The Proposed Changes

The proposed changes would generally cap the current employee stock option deduction by applying a $200,000 annual vesting limit on employee stock option grants based on the fair market

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[1] Dep't of Fin. Can., 1984 Budget, Budget Papers, at 9 (Feb. 15, 1984); *see also* Dep't of Fin. Can., 2000 Budget, Budget Plan, Tax Measures Supplementary Information and Notices of Ways and Means Motions, at 230–31 (Feb. 23, 2000).

[2] R.S.C. 1985, c. 1 (5th Supp.), as amended. Unless otherwise indicated, all references to "section," "subsection," or "paragraph" herein are to sections, subsections, or paragraphs of the Act.

[3] This deduction is available only if the conditions in paragraph 110(1)(d) are met.

value of the underlying shares at the time the options are granted.[4] An option would be considered to vest when it first becomes exercisable, and the determination of when an option vests would be made at the time the option is granted.

The $200,000 limit on the amount of employee stock options that may vest in any calendar year would generally apply to all stock option agreements between the employee and the employer. Under the ordering mechanism in proposed subsection 110(1.31), the $200,000 annual vesting limit would be applied to stock options by taking them into account in the order in which they were granted. In other words, if the amount of stock options that may vest in a year exceeds $200,000, those options granted first would be the first to qualify for the stock option deduction. Where an employee has a number of identical stock options and some qualify for the existing treatment while others are subject to the new rules, the employee would be considered to exercise the stock options qualifying for the existing treatment first.

For employee stock options granted in excess of the $200,000 annual vesting limit ("non-qualified securities"), the employer would be entitled to an income tax deduction with respect to the stock option benefit included in the employee's income, which could be claimed in the taxation year that includes the day on which the employee exercised the stock option. Generally, employers subject to the new rules would also be able to choose whether to grant employee stock options subject to the current tax treatment, up to the $200,000 annual vesting limit per employee, or designate employee stock options as non-qualified securities ineligible for the employee stock option deduction (and instead eligible for a corporate income tax deduction) under the terms of the stock option agreement.

Finally, in cases where a share to be issued or sold under an employee stock option agreement is a non-qualified security, and therefore ineligible for the employee stock option deduction, the employer would be required to satisfy the following notification requirements under proposed subsection 110(1.9):

> **(a)** notify the employee in writing that the security is a non-qualified security on the day that the agreement is entered into, if the security is deemed to be a non-qualified security because of [the $200,000 annual vesting limit]; and
>
> **(b)** notify the [Canada Revenue Agency] that the security is a non-qualified security in prescribed form filed with its return of income . . . for the taxation year that includes the time that the agreement is entered into.

The proposed changes would apply to employee stock options granted on or after January 1, 2020.

[4] The proposed changes would apply to employee stock options granted by employers that are corporations or mutual fund trusts. Employee stock options granted by employers that are Canadian-controlled private corporations ("CCPCs"), however, would not be subject to the new rules.

Competitiveness Concerns

TEI's principal substantive concern with the proposed new rules involves the ordering mechanism in proposed subsection 110(1.31), which has the potential to produce anomalous and anticompetitive results. Most notably, it could lead to troubling cases where employees receive no stock option deduction for the exercise of "in the money" options because the $200,000 annual vesting limit is applied first to previously granted options that are either "out of the money" or expired.

To illustrate this potential for incongruous results, consider the following example in which *A* is an employee of a corporation subject to the proposed new rules:

- In Year 1, *A*'s employer grants him stock options to acquire 100,000 shares at a price of $3 per share (the fair market value of a share on the date the options are granted), vesting and expiring in Year 3.

- In Year 2, *A*'s employer grants him stock options to acquire 100,000 shares at a price of $1 per share (the fair market value of a share on the date the options are granted), also vesting and expiring in Year 3.

- In Year 3, *A* exercises all of the Year 2 options, by which time the market price of the company's stock has partially rebounded to $2 per share.

In Year 3, only the Year 2 stock option grants are "in the money" and exercisable due to fluctuations in the company's stock price. On exercise, however, *A* would realize a stock option benefit of $100,000 without the benefit of any corresponding stock option deduction. Under the ordering rule in proposed subsection 110(1.31), the $200,000 annual vesting limit would be applied entirely to the Year 1 options based on the fair market value of the underlying shares at the time the options were granted ($300,000), eliminating any deduction for the Year 2 options.

In practice, a standard employee stock option plan would provide grants every year, with options vesting annually over a period of three to seven years. As a result, portions of several grants will vest in any given year and potentially create this undesirable consequence over multiple years, depending on the volatility of the employer's stock price. From an employer's perspective, this inequitable result would reduce the value of compensatory stock option plans to attract and retain key employees, and would negatively affect Canadian companies' ability to compete for global talent.

TEI's Recommendation

In view of the government's aim to foster a fair, efficient, and competitive tax system, TEI recommends that employees be empowered to elect the stock options to which the proposed $200,000

annual vesting limit would apply. And in cases where no employee election is made, the $200,000 limit should be applied first to those stock options with the lowest exercise price, rather than the earliest grant date. Employees would be responsible for making such elections with their employers by January 1 of each calendar year, which would ensure that employers have the necessary information to withhold and remit the appropriate amount of tax for each exercise, as well as report the correct amounts of stock option benefit and deduction during the year. Most importantly, however, this approach would avoid the arbitrary and inequitable result in the example above, where "out of the money" options can consume an employee's entire $200,000 annual vesting limit.

In short, TEI believes that an elective approach, coupled with a modified default ordering rule, is the best way to ensure that a stock option deduction is not inappropriately denied solely due to volatile stock prices. Ensuring the availability of a stock option deduction to all employees would further the government's objective of allowing employers to attract and retain talented employees.

Efficiency Concerns

As set forth above, the proposed changes would make it the employer's responsibility to ensure compliance with the new $200,000 annual vesting limit. Under proposed subsection 110(1.9), the employer would be required to both (a) notify the employee in writing that the security is a non-qualified security on the day the stock option agreement is entered into and (b) notify the CRA of the non-qualified security in prescribed form filed with its income tax return for the taxation year that includes the day the agreement is entered into. If enacted, these proposed notification requirements would not only impose an undue administrative burden on employers but also add undue complexity to the Canadian tax system.

Many compensatory stock option plans grant employee stock options every year that have vesting periods covering several overlapping years. Some employee stock option agreements also allow for partial exercises, whereby the employee may exercise only a portion of a particular grant. Requiring employers to track multiple grants with overlapping vesting years and partial exercises would constitute a significant addition to an already complicated administrative function. Each employee's situation is unique, with different amounts of stock options granted and exercised annually. The customized tracking and reporting that the proposed changes would require with respect to each participating employee would result in an inordinately burdensome and time-consuming process that many employers would struggle to implement and maintain. Moreover, the complexity of the proposed new rules would compel many employers to incur substantial up-front systems and training costs. Even payroll departments would have to significantly alter their accounting and reporting systems to ensure that the correct amount of tax is withheld and remitted in each case—a particularly challenging task for employees whose income may not be subject to tax at the highest marginal tax rate.

TEI's Recommendations

TEI respectfully recommends that the Department of Finance reconsider the substantial recordkeeping, reporting, and compliance requirements associated with the proposed new rules. One area that is particularly ripe for simplification involves the notification requirements in proposed subsection 110(1.9). Those rules could be greatly simplified by, for instance, permitting employers to use the same "prescribed form" to notify both the employee and the CRA on an annual (year-end) basis. At the minimum, however, TEI urges the Department of Finance to delay the application of the proposed changes by at least 12 months to afford adequate time for employers to develop the necessary knowledge, systems, and processes to comply with the new rules.

TEI appreciates this opportunity to participate in the consultation process. We urge the Department of Finance to recognize the significant competitiveness and efficiency concerns raised by the proposed changes, and work with stakeholders to craft more competitive and administrable rules with which employers can comply at a reasonable cost. TEI and its members stand ready to assist the Department of Finance in this regard.

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These comments were prepared under the aegis of TEI's Canadian Income Tax Committee, whose chair is Kurtis L. Bond, in coordination with Watson M. McLeish, tax counsel for the Institute. Should you have questions about TEI's comments, please contact Mr. Bond at (403) 260-1156 or Kurtis.L.Bond@conocophillips.com, or Mr. McLeish at (202) 470-3600 or wmcleish@tei.org.

Respectfully submitted,

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International President

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