

December 3, 2015

The Honourable Bill Morneau
Minister of Finance
Department of Finance Canada
140 O'Connor Street
Ottawa ON K1A 0G5

Dear Minister Morneau,

Re: Proposed changes to the taxation of employee stock options – Deloitte's comments

We would like to offer our congratulations to you as Canada's new Minister of Finance and to the Liberal Party that has formed Canada's new Government. It is our hope that the next few years will bring economic opportunity and prosperity for Canadians.

In this letter, we provide our comments on the preliminary proposals regarding the taxation of employee stock options that were put forward during the recent election campaign. It is our understanding that while the basic principles underlying the changes have been determined, the technical details are currently under consideration. As Canada's largest professional services firm with a diverse client base, both domestic and international, we believe that our experience has provided us with the opportunity for extensive insight into the stock option rules and their implementation in various industries.

We commend the Government in its decision to provide for grandfathering provisions upon introduction of the new stock option regime. This certainty is greatly appreciated and will ensure that investment decisions will be made without undue emphasis on tax consequences at the possible expense of business stability. We hope that our comments below will be of assistance to you as you move forward in developing legislative proposals. We would recommend, however, that you consider consulting with stakeholders during this process.

Employee stock option taxation – background

Since 1985, the Income Tax Act (the Act) has facilitated the investment by Canadian employees in the shares of their employers through the preferential tax treatment of stock options and, in particular, the deductions set out in paragraphs 110(1)(d) and 110(1)(d.1). In the 1984 federal budget, the provisions were announced as a measure to "provide such employees with incentives directly related to their ability to increase the productivity, competitiveness, and growth of their company".

These amendments had the desired effect and stock options have become a key element of compensation planning, ensuring that that Canadian employees receive and Canadian employers provide compensation competitive with their global counterparts.

The use of stock option plans is widespread and long standing, notwithstanding the tax disadvantages to the employer. While recent commentary has focused on the narrow band of high income individuals who profit under such programs, in fact, certain employers have consistently awarded options to a broad range of employees.

In determining the number of options to be issued to employees and the attributes of the option plan (performance vesting, time vesting etc.) employers retain experts in compensation design to conduct detailed surveys and modelling. Modifications to the taxation of stock options will likely significantly affect the modelling logic and the process used to structure these awards.

Deloitte's comments - some issues for consideration

Ordering of option exercise

With the introduction of grandfathering provisions, it will be incumbent upon employers to identify which specific options are being exercised in order to determine the applicable tax rates and, in some situations, the timing of taxation.

This will be a reasonably straightforward exercise where options are granted with fluctuating strike prices. However, in some circumstances involving private corporations, the exercise price may either be a negligible amount or it may not fluctuate due to a stable fair market value.

We recommend the reintroduction of subsection 7(12) of the Act to clarify this issue and simplify the process to be used by both employers and employees in identifying which options have been exercised.

Start-up corporations

We understand that special consideration may be given to stock options issued by start-up corporations. We commend the Government's recognition of the importance of entrepreneurship to the Canadian economy and the cash flow challenges related to such entrepreneurship which could make it difficult for such companies to attract top talent.

From a pragmatic perspective, start-up corporations, being illiquid companies with little or no active market for the shares, could face a significant disadvantage without special consideration. The tax obligation arising upon exercise of the options except where the shares are of a Canadian-controlled private corporation, would be onerous because the employee would not be able to sell some of the shares in the market to cover the tax liability. Thus, where tax remittances are not deferred, many employees may lack the cash required to pay the exercise price and the tax. Tax should not dictate investment decisions.

We therefore endorse a deferral mechanism for employee stock options of start-up corporations and recommend that the Government consider extending such deferral to all private corporations whose shares are illiquid due to the lack of a ready market for the shares.

Corporate deduction

As steps are taken to reduce or eliminate the preferential tax treatment of the stock option benefits realized by employees, we submit that it would be appropriate for the Government to amend paragraph 7(3)(b) of the Act to enable the employer to claim a deduction when options are exercised.

This would align the Canadian tax system with the employee stock option taxation regimes in a number of other countries in which the employer can either generally claim a deduction when treasury or newly issued shares are delivered to an employee or claim a deduction for such shares where the employee does not receive preferential tax treatment. Typically, the deduction will equal the fair market value of the shares less the amount paid by the employee upon exercise of the option. For example, in the United States, an employer deduction for “non-qualified” stock options can be claimed at the time the amount is included in the employee’s income. A non-qualified stock option is an option in respect of which an employee cannot claim preferential tax treatment upon the exercise of the option. The rules in the United Kingdom are even more generous. In that jurisdiction, the employer can claim the deduction even where employees participate in programs that provide individual preferential tax treatment. We submit that in light of the elimination of the personal tax preferences, it is appropriate for Canada to adopt the position of other major tax jurisdictions and enable Canadian employers to claim a similar deduction.

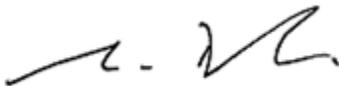
While we appreciate that this deduction will detract from the potential revenue raising opportunities, it is important to acknowledge the fact that compensation programs are not static. In the face of the elimination or restriction on the stock option deduction, it is reasonable to expect that employers will consider alternate programs. In the event that no employer deduction is permitted for such stock settled programs, we anticipate that a number of corporations will migrate to alternative programs, such as cash settled stock appreciation rights, where there is no impediment to the corporate deduction.

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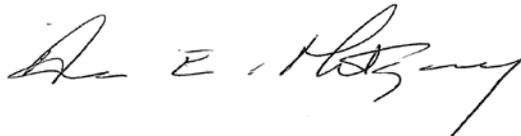
Deloitte is committed to making a significant contribution to help shape Canada’s tax policy. We would welcome the opportunity to meet with you to discuss our views on the employee stock option proposals. Please feel free to contact the undersigned with any questions or to arrange a meeting.

Yours truly,

Deloitte LLP



Albert Baker, FCPA, FCA
Partner, Tax Policy Leader



Anne Montgomery, LLB, MBA
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Copies to: Mr. Brian Ernewein, General Director, Tax Policy Branch, Department of Finance Canada
Mr. Andrew Marsland, Senior Assistant Deputy Minister, Department of Finance Canada