Intelligence MEMOS

From: Nick Pantaleo

To: The Hon. Bill Morneau, Minister of Finance

Date: August 1, 2019

Re: **Improving Ottawa's Changes to the Tax Treatment of Employee Stock Options**

In Budget 2019, the federal government announced its intention to correct a significant inequity of the Canadian personal tax system relating to the employee stock option deduction, which effectively allows employment income earned by high-income/wealthy Canadians to be taxed at capital gains rates.

The tax policy objective underlying the stock option deduction is aimed at allowing smaller, growing companies, such as start-ups, which do not have significant profits, and may have challenges with cash flow that limit their ability to provide adequate salaries, to hire talented employees. Employee stock options are seen as helping these companies attract and retain talent by allowing them to provide a form of compensation that is linked to the future success of the company.

Notwithstanding the tax policy objective, the government finally acknowledged that the tax benefits of the employee stock option deduction disproportionately accrue to a very small number of high-income individuals – resulting in a tax treatment that unfairly benefits the wealthiest Canadians.

In its recently issued Backgrounder, the finance department notes that in 2017, 2,330 individuals, each with total annual incomes of over $1 million, claimed more than $1.3 billion in employee stock option deductions. In total, these 2,330 individuals, representing 6 per cent of stock option claimants, accounted for almost two-thirds of the entire cost of the deduction to taxpayers.

A government interested in gender-based policy analysis might note that a deeper dig into these numbers (with the help of data provided by Statistics Canada), reveals that most of the wealthy who benefit from the stock option deduction are male. In 2017, 66 percent of those earning more than $200,000 were male, a share that rose to 76 percent for those earning over $250,000.

While, the draft of the new legislation intends to establish a fairer employee stock option tax regime, I believe the proposals fail to adequately address the inequity that the government seeks to address. Wealthy Canadians will still benefit from the employee stock option deduction.

The department's backgrounder provides no evidence or support that the employee stock option deduction is achieving its goal to help smaller, growing companies. Since other longstanding measures to support such companies exist, it may be acceptable to give the government a "pass" in this regard, even if the price is some tax leakage in the Canadian tax system.

But clearly a line should be drawn where it can be. In this case, that line should ensure that wealthy Canadians do not benefit from the deduction, especially when the government has failed to address other inequities that result in lower and middle-class Canadians paying higher effective income tax rates as outlined here and here.

To better ensure the government's objective "…that the employee stock option tax regime becomes fairer and more equitable for Canadians," the proposals should include an income test to exclude individuals earning more than $200,000 (including deferred compensation, such as pension benefits) in the period the options are outstanding, including the year the options are exercised.

In addition, or in the alternative, the lifetime employee stock option deduction available to all individuals should be capped at $500,000.

Finally, the employee stock option deduction should be treated in the same manner as the capital gains deduction for other purposes of the *Income Tax Act*. For example, the total employee stock option deduction daimed by a taxpayer over his/her lifetime should reduce the amount of net capital losses available to offset non-capital gains income in the year of death.

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