

# Intelligence MEMOS



From: Nick Pantaleo  
To: The Hon. Bill Morneau, Minister of Finance  
Date: January 13, 2020  
Re: **IMPROVING OTTAWA'S CHANGES TO THE TAX TREATMENT OF EMPLOYMENT STOCK OPTIONS – PART II**

---

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

The announcement was followed by the release last June of a Notice of Ways and Means Motion intended to establish a fairer employee stock option tax regime.

Just before Christmas, you announced that the proposed changes will not come into force on the previously proposed date of January 1, 2020. Instead, the government will announce details on how it intends to move forward in Budget 2020, including the new coming-into-force rules.

While the announcement was no doubt welcomed by the small group of Canadian high-income earners that benefit most from the deduction, you should explain to Canadians why you are taking so long to fix this inequity, an inequity your party identified and promised to correct as part of its 2015 election platform.

In my August [Intelligence Memo](#), I indicated that the Ways and Means motion failed to adequately address the inequity because wealthy Canadians would still benefit from the employee stock option deduction. I suggested there should be an income test to exclude individuals earning more than \$200,000 (excluding stock option benefits but 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 for all individuals should be capped at \$500,000. (I also suggested that the deduction be treated similarly to the capital gains deduction for other purposes of the *Income Tax Act*.)

The pre-Christmas announcement suggests a closer examination of the government's approach to fixing the issue, which seems focused on identifying circumstances when the stock option deduction should not be permitted, as if the deduction were a cast-in-stone, fundamental tax principle or rule that must be sustained. It is not!

The stock option deduction is a tax expenditure or subsidy. As the government points out, the deduction is intended to assist smaller, growing companies with limited profits and cash flow to attract and retain talented staff. It does so by making employee stock options a more attractive form of remuneration by effectively taxing only 50 percent of stock option benefits.

What is lost is that a stock option benefit is employment income and all employment income should be fully taxed. Full taxation of employment income is the fundamental tax principle or rule that is relevant. The stock option deduction is an exception, not the rule. In other words, the government is seeking to determine "exception(s)" to the "exception" to the fundamental tax principle or rule. No wonder it is struggling to find the right fix.

Tax expenditures encourage and/or support desired taxpayer behaviour to, among other things, enhance economic growth and prosperity for all Canadians. They can also modify the tax base in ways that are socially desirable and accepted on horizontal and vertical equity grounds. That is not the case with the current stock option deduction.

Horizontal equity is not achieved since the stock option benefit is not being fully taxed like other employment income. Further, vertical equity is not achieved because the government's own figures strongly infer that a disproportionate amount of the stock option deduction goes to high-income earners.

The fix, therefore, is actually very simple: eliminate the stock option deduction.

Yes, the task of assisting smaller, growing companies to attract and retain talented staff would remain. Perhaps these companies could be granted a special equity deduction for corporate income tax purposes equal to the stock option benefit.

The government is probably more inclined to preserve the stock option deduction and restrict it to yet-to-be-defined start-ups or small, growing companies, not to large, long-established, mature companies. Any such definitions are bound to be subjective, complicating both administration and compliance for the Canada Revenue Agency and taxpayers.

If that indeed is the outcome, one hopes the government will at least limit the annual and lifetime benefit obtained by high-income earners. It would not be the perfect solution. But, after all, it is not a perfect world.

*Nick Pantaleo, FCPA, FCA is a retired executive of Rogers Communications and a former tax partner of PwC LLP. He is currently Executive in Residence at the University of Waterloo's School of Accounting and Finance.*

To send a comment or leave feedback, email us at [blog@cdhowe.org](mailto:blog@cdhowe.org).

*The views expressed here are those of the author. The C.D. Howe Institute does not take corporate positions on policy matters.*