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## Standing Committee on Finance

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EVIDENCE

**Thursday, June 10, 2010**

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**Chair**

**Mr. James Rajotte**



## Standing Committee on Finance

Thursday, June 10, 2010

• (1530)

[English]

**The Chair (Mr. James Rajotte (Edmonton—Leduc, CPC)):** I call meeting number 26 of the Standing Committee on Finance to order.

Our orders today, pursuant to Standing Order 108(2), are to study taxation of employee stock options.

Colleagues, we have two witnesses with us here today. From the Department of Finance, we have Mr. Baxter Williams, director of personal income tax division, tax policy branch. Welcome, Mr. Williams. We also have Mr. Miodrag Jovanovic, senior chief, saving and investment section. Welcome to you as well.

Just remember, colleagues, you do have the initial motion adopted by this committee on June 2. We also have the response from the minister of August 31, 2009. We also have the measures in the budget of March of this year. Then, of course, this hearing is a result of this committee's adoption of Mr. McCallum's motion following up on this issue.

I understand our witnesses have a few brief opening comments. Mr. Williams, do you have a brief opening statement?

**Mr. Baxter Williams (Director, Personal Income Tax Division, Tax Policy Branch, Department of Finance):** Yes.

Thank you for extending the invitation. We will be pleased to answer any of your questions to the best of our abilities.

I just thought before we begin it might be worth reviewing measures implemented in the last budget, which in large part address some of the concerns initially raised in the letter. But before doing so, I'd just like to provide some context around the underlying framework in which we developed this measure and the principles involved.

The starting point for this is to consider the nature of an employee stock option. The benefit it provides through its exercise is derived as a result of an individual's employment relationship. In this context, we treat the employee stock option as an employment benefit. Any subsequent gain or loss in the value of the acquired security is treated as a capital gain or loss. The result of this is that an individual who acquires a security by using employee stock options is in a comparable position in terms of the capital gains and losses on the security as someone who acquired it using after-tax income.

Nevertheless, even though you have this comparability in the treatment of the security, employee stock options enjoy a preferred taxation relative to other employment income. Subject to general

conditions, they're eligible for a 50% deduction on the value of the benefit. In addition, the employee enjoys the advantage of being able to defer the underlying benefit value embodied in the option until the point of exercise of the option.

It's important to also consider the potential value of this benefit. The average benefit realized in the exercise of an employee stock option exceeds \$100,000. But perhaps more importantly, one can consider where the bulk of that benefit is realized. Over 75% of the value of these benefits are realized by individuals reporting income in excess of half a million dollars. The benefit they realize on average is \$800,000. So we're not dealing with what you might consider working-class individuals when you're looking at the taxation of employee stock options. Given the value of these options, ensuring a fair tax treatment is understandably important.

In the context of Budget 2010, special elective tax relief measures were introduced that limited the value of the tax liability associated with the deferred stock option benefits to the proceeds realized from the disposition of the shares. This measure was implemented in recognition that many individuals may not have fully realized the implications of the tax deferral measure introduced in Budget 2000 and the potential financial liabilities that could arise. It was part of a package of measures implemented to ensure that similar situations did not arise in the future. That included the elimination of the deferral measure, and in addition a clarification of existing withholding rules to ensure that employers put in place the systems necessary to remit the tax liabilities associated with the exercise of an option upon its exercise.

That concludes my remarks.

• (1535)

**The Chair:** Thank you very much, Mr. Williams.

We'll start members' questions with Mr. McCallum for seven minutes, please.

**Hon. John McCallum (Markham—Unionville, Lib.):** Thank you very much.

I think you've seen the proposal that we put forward in our motion. Is the proposal in the budget similar to what we said, is it totally different, or what's the relationship between the two?

**Mr. Baxter Williams:** I think you need to distinguish between the result and the underlying principle. In one regard, it addresses many of the concerns that may underlie the motion you introduced, in ensuring that individuals who took advantage of the deferral measure were not financially disadvantaged as a result of doing so.

I guess in another regard it's quite different, because it's consistent with the existing principle on which we tax employee stock options, whereas what you were proposing in the motion was to provide a full offset, so that an individual would be able to apply any capital loss on the security against employment income.

Our concern with that is that it would provide an advantage to individuals who had acquired shares through the exercise of options, relative to the large population of other shareholders who had acquired their shares using after-tax income.

So in summary, my answer is yes and no.

**Some hon. members:** Oh, oh!

**Hon. John McCallum:** Well, let me quote part of the budget. It says:

an amount equal to half of the lesser of the stock option benefit and the capital loss on the optioned securities will be included in the taxpayer's income as a taxable capital gain.

Is the effect of that not similar to what we proposed in our resolution?

**Mr. Baxter Williams:** Well, the mechanics of the measure are designed to ensure that an individual doesn't get a double benefit from the measure. If you simply said that the value of your liability is limited to what you realize on disposition, the individual would still have all the accumulated capital losses associated with the depreciation of those securities and would be able to apply those capital losses over any future capital gains.

The way the budget mechanism works is that it attributes a capital gain equal to the losses you've incurred because of the depreciation of the stock, thereby wiping out those losses, and then gives you the forgiveness. I think the clause you're referring to is that mechanism by which we remove the accumulated capital losses associated with the security.

**Hon. John McCallum:** The reason I'm asking these questions is that I'm a bit puzzled, since the effect of what we were proposing is at least similar to the effect of what's in the budget. Yet in his letter, the minister talks about how our proposal would compromise the integrity of the tax system and how it was counter to sound tax policy principles. Then he goes ahead and does something quite similar.

**Mr. Baxter Williams:** I guess the distinction is that in the context of providing a general loss offset, and I think as the letter notes, on employee stock options you would create a precedent within the tax system on a fairness basis to provide a similar ability to apply capital losses against other income for all shareholders.

What we tried to do was implement a targeted measure that provided a practical solution to an understandable misunderstanding of the law that has occurred among some individuals, at the same time as avoiding making a general pronouncement on the appropriate taxation of employee stock options.

In this regard, it's worth noting that the measure is only limited to those individuals who took advantage of the deferral measure, and it's tied to the elimination of the deferral measure.

• (1540)

**Hon. John McCallum:** Thank you very much.

[*Translation*]

**The Chair:** Go ahead, Mr. Carrier.

**Mr. Robert Carrier (Alfred-Pellan, BQ):** Thank you, Mr. Chair.

Good day, Mr. Williams, Mr. Jovanovic.

While you're here, I'd like to ask you a question that is unrelated to our motion. It concerns the fact both the employer and the employee can claim a deduction for cashing in stock options. If businesses were no longer able to claim the deduction, what impact would this have on government revenues?

[*English*]

**Mr. Baxter Williams:** I can't recall the figure exactly, but I think the revenue impact was about \$300 million a year. Was it \$270 million the first year?

I could give you the exact number; we have it right here.

[*Translation*]

**Mr. Robert Carrier:** That figure represents the amount that both the business and the employees could claim when stock options are cashed in. Is that correct? If only the business half of the deduction were eliminated, would the savings also be in the order of \$300 million?

[*English*]

**Mr. Baxter Williams:** I think it's worth taking a second to consider the design of the measure.

Under the previous system, in which you had tandem stock option rights, the use of these rights would result in a situation in which the employee, by cashing in the option, would still be entitled to the 50% deduction and the employer could fully deduct the cash payment. In this sense, a certain portion of that payment escaped taxation at either the corporate level or the individual level.

What we did is effectively require the employer and employee to choose who gets the deduction. We eliminated one half of it. As a result of that, if the employee exercised the option, they would still be entitled to the 50% deduction. In that case, the employer, by virtue of issuing shares rather than cash, would not receive the deduction they would have otherwise obtained.

If the employee continues to choose cash, generally speaking, unless a mutual arrangement is established between the employee and employer, the employee is fully taxed on that income, as they would be on any other employment income, and the employer can fully deduct the amount.

So you have a system in which there's a choice involved. We can estimate the overall revenue impact of that, but the specific allocation of that revenue cost to either the employee or the employer will depend on the nature of the choice that's made.

We know we're getting our half, but we don't know from whom, in simple terms.

[*Translation*]

**Mr. Robert Carrier:** I see.

So then, what you're telling me is that the employee has the first option of claiming the deduction. If he chooses not to claim it, then the employer can. Is that right?

[English]

**Mr. Baxter Williams:** More or less, I think that's a good summary.

[Translation]

**Mr. Robert Carrier:** Fine.

I have no further questions.

[English]

**The Chair:** Merci.

We'll go to Mr. Wallace, please.

**Mr. Mike Wallace (Burlington, CPC):** Thank you, Mr. Chair.

I will not be taking the seven minutes. I don't think we need to. I think we've resolved most of the issues that were highlighted, and I appreciate the Liberal opposition's having brought it forward. We had people come to my office to talk to me about it. I think, based on—I know it's shocking—working together, with you guys bringing an issue forward and the minister moving on it and the staff bringing it forward in Bill C-9.... I appreciate the change.

Just for my understanding, though, this is not just a go-forward measure. How will this affect those who are from JDS or Nortel, who have been caught in the issue they had? Or is it just a go-forward measure?

**Mr. Baxter Williams:** You actually have two questions there, and they both deserve separate answers.

• (1545)

**Mr. Mike Wallace:** Okay. I'll take them.

**Mr. Baxter Williams:** The employment benefit is available to all options associated with any deferral since 2000. In that regard, it's a go-forward and a go-backward measure.

The second question is how it will affect JDS and Nortel.

Nortel options, in which the employment benefits were deferred, would generally benefit from this measure.

**Mr. Mike Wallace:** Okay.

**Mr. Baxter Williams:** JDS's wasn't an employee stock option plan; it was an employee share purchase plan.

**Mr. Mike Wallace:** Oh, okay.

**Mr. Baxter Williams:** CRA has already looked after it through a remission order.

**Mr. Mike Wallace:** Okay. I appreciate that.

For my clarification, it was the deferral piece that caused us the issue. Are we getting rid of the deferral option that's there, for tax purposes?

**Mr. Baxter Williams:** That's right, the deferral has been eliminated.

**The Chair:** Thank you, Mr. Wallace.

Monsieur Mulcair.

[Translation]

**Mr. Thomas Mulcair (Outremont, NDP):** Mr. Chair, I'll try and be as brief as my colleague Mr. Wallace.

First of all, I want to thank Mr. Williams.

We haven't heard from you, Mr. Jovanovic, but your presentation represents the very best the public service has to offer. It was amazingly clear. Although it touched on quite a dry topic, namely the benefits associated with employee stock options, people will have learned something about the process, because your presentation was, from an educational standpoint, extraordinarily clear.

We worked for three years with Nortel employees who were caught in an unexpected bind. As Mr. Wallace so aptly stated, these individuals were able to testify because of the work of this committee. The solutions were provided mainly in the budget. Personally, I'm very satisfied with the collaborative approach adopted here. Sometimes, the tools employed produce results that no one can anticipate. This was one such case. I'm very pleased with the outcome and again, I think today's presentation represents the best that Canada's public service has to offer.

[English]

**The Chair:** Merci, Monsieur Mulcair.

**A voice:** Oh, I have a tear.

**Mr. Mike Wallace:** Ask for a raise when you get back.

**Mr. Baxter Williams:** Please pass it as a motion.

**Voices:** Oh, oh!

**The Chair:** Order.

Ms. Hall Findlay, please.

**Ms. Martha Hall Findlay (Willowdale, Lib.):** Thank you, Mr. Chair.

Thank you, Mr. Mulcair. That was a moment.

This is not in the budget implementation bill. Pretty much everything and the kitchen sink is in the budget implementation bill. Do you have any idea why this is not?

**Mr. Baxter Williams:** I think because of its technical nature, and the timelines associated with the budget implementation bill, it wasn't possible to include full legislative language in the bill. I think consistent with standard practice, we would be introducing subsequent bills to enact the remaining proposals that are in the budget, and I would expect it would be addressed at that time.

**Ms. Martha Hall Findlay:** Given that we're almost at the end of our session, and will see the budget implementation bill likely pass with everything and the kitchen sink in it, if this will have to be delayed until the fall, for example, do you expect any negative consequences from that, or will it be covered off at that point?

**Mr. Baxter Williams:** I can't foresee any negative consequences associated with its delay.

**Ms. Martha Hall Findlay:** Because of the first answer to Mr. Wallace too?

**Mr. Baxter Williams:** Yes.

**Ms. Martha Hall Findlay:** Okay. Thank you.

**The Chair:** Thank you, Ms. Hall Findlay.

Monsieur Dufour.

[*Translation*]

**Mr. Nicolas Dufour (Repentigny, BQ):** Mr. Chair, it would appear that I'm the only one who has questions today for the witnesses.

My first question is for Mr. Williams.

In the United States, stock options are treated like capital gains, whereas in Canada, the benefit can be claimed as a deduction.

Could you explain the difference between the two treatments and the associated advantages, or disadvantages?

• (1550)

[*English*]

**Mr. Baxter Williams:** I guess in the States it's important to distinguish between statutory stock option plans and non-statutory plans, because the treatment associated with the two is considerably different.

The value of the bulk of employee stock options in the States is realized through non-statutory plans. In this case they're taxed as any other employment benefit, in that there is no capital gains treatment associated with it. They're taxed at full rates. Subject to certain conditions around withholding periods, the maximum value of the benefit, and the maximum value of the benefit vesting, statutory plans will receive certain tax considerations, such as the ability to delay the taxation of the benefit until exercised.

I think on an overall basis, the Canadian system provides a more competitive treatment, in that we have put in place general conditions under which you can receive a 50% deduction on the value of the benefit.

[*Translation*]

**Mr. Nicolas Dufour:** Thank you very much.

I understand the principle of employee stock options. Clearly, the purpose behind them is to attract highly qualified employees and keep them here in Canada. However, there's something I don't quite understand. I'm looking at table A5.3 on page 388 which shows the distribution of stock options by income for the year 2007. One thing that strikes me in particular are the average values.

Just between you and me, if we look at the average values for a person earning less than \$100,000 a year and those values for a person earning in excess of \$500,000 a year, it becomes apparent that there is no point in having an average value.

I'd be curious to know what the actual median is. That figure would probably be more interesting than the average value. Do you have an idea of the median value of employee stock options?

**Mr. Miodrag Jovanovic (Senior Chief, Saving and Investment Section, Department of Finance):** Unfortunately, we do not have that information, but if you like, we could get it to you later.

**Mr. Nicolas Dufour:** Excellent. Thank you very much.

However, if we do a broader breakdown...There is nothing for incomes over \$500,000. Persons earning \$1 million, \$2 million or

\$3 million a year are not taken into consideration. If we look at your table, we see that 75% of the pot was divided up among those earning in excess of \$500,000. These represent financial losses for the Government of Canada and therefore, for all taxpayers. I'd be curious to know what share of this 75% went to persons with total incomes of \$1 million. The greater the breakdown, the higher the income level becomes and the greater the share of the pot for those in the very high income brackets.

It is very surprising to see that given the way in which this stock option proposal was drawn up, only 7,985 persons will receive an average of \$393,000, whereas persons earning between \$100,000 and \$500,000—and there are many more people in that category—will receive far less than that.

Would there not have been some way to provide for the more progressive cashing out of stock options to ensure a much more equitable distribution of the funds?

**Mr. Miodrag Jovanovic:** You have raised a valid argument and essentially, that is what this table highlights, namely that very high income earners benefit the most from the distribution process. Under the circumstances, it is even more important to ensure that our position strikes a fair compromise between the need to remain competitive internationally and the need to have, generally speaking, a fair and equitable system. That is what this policy is designed to achieve.

**Mr. Nicolas Dufour:** But I do not see much—

Fine. Thank you.

[*English*]

**The Chair:** Merci.

I want to thank you and second what Mr. Mulcair said in terms of your explanation here today.

I have a general question.

I was approached after the budget was introduced, and there were some discussions back and forth. It seems what some people want, further to what was put in the budget, is a further discussion in terms of what constitutes income of an employee and in terms of looking further at how stock options are addressed.

Are there any ongoing discussions within the department in terms of broadening the definition of employment income or of looking at the stock option issue in a more general way?

• (1555)

**Mr. Baxter Williams:** We saw this as a package that addressed outstanding concerns associated with employee stock options. We're not aware at this time of larger issues associated with their tax treatment.

We generally take a comprehensive approach to taxing employment income: any benefit, whether in kind or in cash, is considered taxable. In a broad sense, the treatment of employee stock options is consistent with that approach.

**The Chair:** Have you heard concerns that even with the changes that will happen here, there still is perhaps a disadvantage with respect to some other countries in terms of trying to attract talent, especially for smaller companies that cannot provide a large income at that stage, but that could provide a lot of stock options to attract these people?

**Mr. Baxter Williams:** I think some people have expressed a different view about whether an employee stock option should be treated as an employment benefit. That is true, although I've tried to provide the rationale for the approach that we've taken in the budget and in general.

Does that address your questions?

**The Chair:** Yes. Thank you.

Are there any other questions?

**Mr. Mike Wallace:** I move to adjourn—

**Mr. Baxter Williams:** Actually, do you mind if I have a follow-up response, just in terms of the equity?

One of the consequences of the elimination of the double deduction is that, as with something like dividend income, you ensure that from both a corporate and an individual perspective,

options are taxed in a way that is broadly comparable to how employment income would be taxed, so you have a situation in which the benefit provided by the option does not provide a deduction to the employer, but the employee receives a 50% deduction. In this sense we see this measure as achieving a certain comparability in the treatment of options relative to other employment income. That is important, given the distribution of the benefits the measure provides.

We actually have what I think is an interesting chart to that effect on page 354. It shows the taxation of employment income and its impact at the corporate level as well as at the individual level. You may find that interesting.

**The Chair:** Okay. Thank you.

I want to thank both of you for being with us here today. Perhaps it's my bias as chair of this committee, but I think it shows some good work by both this committee and the department in addressing a very real and serious issue for a lot of Canadians.

I want to thank all of you for being here today.

The meeting is adjourned.

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