Written Submission for the Pre-Budget Consultations in Advance of the 2020 Budget

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Recommendations

Recommendation 1: The Income Tax Act should be amended retroactively to permit middle class Canadians to transfer the entire commuted value of their pension benefit to another deferred retirement plan.

Recommendation 2: The employee stock option deduction proposals should include an income test such that individuals earning >$200K annually (including deferred compensation, such as pension benefits) in the period the options are outstanding, including the year the options are exercised, are ineligible for the deduction. 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 similar to the capital gains deduction for other purposes of the *Income Tax Act*. For example, the total employee stock option deduction claimed 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.

Addressing the Unfair Tax Cost to Middle Class Canadians on Pension Transfers[1]

A central theme of the government, and a desire of many Canadians regardless of their political views, is to strengthen Canada's middle-class. One way of doing this is through targeted tax relief aimed at making the tax system fairer for middle-class Canadians, especially where such relief is targeted to help the middle-class save and invest to grow the Canadian economy.

There is an area in the Canadian tax system that is failing many middle-class Canadians by taxing prematurely, often at the highest marginal tax rates, their pension savings – for many, their lifeblood to ensure they are able to sustain themselves and their loved ones financially in their senior years.

Meet Rob: A Member of Canada's Middle Class

Rob is a very close friend whom I have known my entire life.

Following his graduation from college, Rob took on a job with one of Canada's then iconic companies as a skilled mechanic responsible for his employer's heating and air conditioning systems. Rob was a full-time employee at the company for almost 40 years, earning an average annual salary of about $55,000. In 2017, Rob was forced to take early retirement because his role was being outsourced to a third-party. This occurred at a time when his company was struggling financially and would soon cease operations in Canada.

Rob was a member of his employer's defined benefit pension plan. On his retirement, he was given several options for the pension benefit he had accumulated. However, he was forced to take a "haircut" on his pension benefits because of his employer's dire financial situation and because the plan was underfunded. Rob ended up taking the commuted value of his pension benefit as a lump sum payment – about $500,000. This would be Rob's biggest asset and the primary source of his retirement income.

Under the current rules in the *Income Tax Act*, Rob was only able to transfer about 55% of the commuted value to an RRSP on a tax-deferred basis. The rest was subject to immediate income tax at tax rates that were much higher than any rate Rob was subject to in the past and would be subject to in the future.

[1] This section is taken substantially from a letter I wrote to the Minister of Finance dated March 14, 2019 and a C.D. Howe Institute Intelligence Memo dated March 19, 2019 (see https://www.cdhowe.org/intelligence-memos/nick-pantaleo-it's-time-end-over-taxation-lump-sum-pension-payouts).

Why is the Government Taxing Rob and Other Middle-Class Canadians in These Circumstances?

It is unfair and inappropriate for Rob to face a tax bill in these circumstances, let alone having to pay income tax at rates he has never being subject to in the past and is extremely unlikely to face in the future.

There is no reasonable tax policy rationale for why Rob, and others in a similar situation, should not be permitted to transfer the entire commuted value on a tax-deferred basis to an RRSP or an equivalent pension saving plan, as the case may be.

The income tax rules covering pension plans are complex. These rules are in urgent need of an update (see, for example, the C.D. Howe Institute's Commentary written by William B.P. Robson's titled "Rethinking Limits on Tax-Deferred Retirement Savings in Canada). In particular, Mr. Robson explains that the so-called "Factor of Nine", which is the measure of the equivalency of saving between the different pension vehicles, is flawed. The rules governing transfers of accrued retirement wealth from a defined benefit pension plan to a registered capital (de)accumulation plan provide a stark illustration of the Factor of Nine's uneven treatment of different tax-deferred arrangements.

There may indeed be a legitimate tax policy debate over the amount taxpayers should be able to defer from taxation when saving for retirement. But this is not the issue in Rob's case. For almost 40 years, Rob met the requirements to enable him to earn a promised tax-deferred pension until he needed the funds to sustain him and his family in his retirement years. The tax rules should not restrict his ability to transfer his pension benefits to another registered plan, let alone apply a flawed equivalency factor, when the result is to reduce the retirement wealth he was counting on, in addition to the "haircut" forced on him by his employer.

Recommendation

The government should acknowledge that middle-class Canadians like Rob are being treated unfairly by the tax system by having to pay income in tax in these circumstances. To remedy this unfair situation, the *Income Tax Act* should be amended to permit the tax-free transfer of the entire commuted value to another retirement plan.

A prospective tax change does not help Rob and the many Canadians that have already been unfairly treated under the current tax rules. Since the government has unfairly profited from middle-class Canadians like Rob, the amendment should be retroactive in order to achieve a fair result. I am confident that officials within the Department of Finance can find creative ways to correct this unfairness and allow middle-class Canadians like Rob to regain the pension wealth they need to sustain their retirement.

Improving the Government’s Proposed Changes to the Tax Treatment of Employee Stock Options

In Budget 2019, the Government's announced its intention to correct one of the significant inequities of the Canadian personal tax system. This inequity relates to the employee stock option deduction that 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 such employees 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 (see https://www.fin.gc.ca/n19/data/19-066_1-eng.asp), the government notes that in 2017, 2,330 individuals, each with total annual incomes of over $1 million, claimed over $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. Digging deeper 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% and 76% of those earning >$200K and >$250K, respectively, were male.

While, the accompanying Notice of Ways and Means Motion is intended to establish a fairer employee stock option tax regime, the proposals fail to adequately address the inequity that the government seeks to address; i.e., wealthy Canadians will still benefit from the employee stock option deduction.

The Backgrounder provided no evidence or support that the employee stock option deduction is achieving its goal to help smaller, growing companies. Since there are longstanding practices to support such companies, it may be acceptable to give the government a “pass” in this regard, even if the cost is some tax leakage in the Canadian tax system. But clearly a line should be drawn where it can. In this case, that line should ensure that wealthy Canadians do not benefit from the deduction.

Recommendation

The employee stock option deduction proposals should include an income test such that individuals earning >$200K annually (including deferred compensation, such as pension benefits) in the period the options are outstanding, including the year the options are exercised, are ineligible for the deduction. In addition, or in the alternative, the lifetime employee stock option deduction available to all individuals should be capped at $500,000.

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