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Employee stock option tax attacked

Federal government says its proposed Income Tax Act changes close benefits loopholes
But B.C. businesses say tax regulation retooling will create a major investment hurdle for startups and companies hungry for IPO opportunities

By Curt Cherewayko

Proposed changes to taxes on employee stock options have further rankled investors and businesses in B.C. who say that federal tax laws for stock options are already too complicated and burdensome.

At a May 6 BC Technology Industry Association (BCTIA) event in Vancouver about 25 executives from B.C. technology companies will hear Jim Fletcher discuss how the tax system devalues stock options as an employment incentive and dissuades private companies from raising capital on the public markets.

Fletcher, who is the managing director of Vancouver-based venture capital firm Chrysalix Energy, has been B.C.'s most vocal opponent of the tax structure on exercised stock options.

He says the new provisions, which were laid out in the federal budget, create further hurdles to innovation in Canada.

Fletcher therefore wants B.C. businesses to join him in lobbying the federal government to remove existing and proposed tax provisions.

In the budget, the federal government said its new rules address tax-planning practices that have allowed, in certain circumstances, stock-based employment benefits to escape taxation at both personal and corporate levels.

The proposed changes, which are part of broader government efforts to close "tax loopholes," include requiring employees to immediately pay tax on options they exercise.

Previously, employees were allowed to defer tax on exercised shares worth less than \$100,000 until they sold the shares.

The proposed changes also make employers liable for the tax if an employee can't pay it.

According to Fletcher, the liability creates more administrative costs and red tape for companies – such as requiring them to operate a separate account to "withhold" capital for the taxes.

In addition, if a company plans to go public and has, for example, dozens of employees with options, it would carry the impossible burden of potentially being liable for millions of dollars in taxes on options that are exercised in a short period of time.

Fletcher wants the Income Tax Act to treat option-owning employees like other shareholders, which would require them to pay capital gains tax only on shares they sell – but no taxes on options they exercise.

According to Fletcher, that would prevent situations in which, for example, an employee exercises a \$1 stock option and pays tax on the \$10 value of the shares, only to see the stock fall to \$3.

The proposed Income Tax Act provisions are scheduled to come into effect next year.

"My hope is that, as others start to work through the incredible administrative, legal hassles and costs of doing this, a groundswell builds and over the course of the year enough pressure mounts on Ottawa that they wake up and do the right thing – which is simply to tax employees on the sale of shares," said Fletcher.

Mike Volker runs two angel funds in B.C.: Western Universities Technology Innovation Fund and GreenAngel Energy Corp. (TSX-V: GAE). He said many employees, particularly executives and management, typically don't exercise options to "cash out." They exercise them because the options are about to expire.

But the proposed provision that requires employees to pay tax immediately on an exercised option would put pressure on some employees to sell their stake if they don't have adequate capital elsewhere to pay the tax.

Volker noted that employee and investor confidence suffers when high-ranking employees sell their stake in a company.

He said stock options are a good recruiting mechanism for startups that are short on cash but need to hire personnel.

However, he added that startups avoid using stock options, preferring to dole out actual shares or founders' shares, both of which have their own tax considerations.

"[The tax structure] is the last biggest single impediment to getting new ventures launched and properly staffed and financed," said Volker, who calls the tax structure an accounting nightmare.

"The stock options that are supposed to be an incentive for employees become a

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huge albatross around their neck.”

BCTIA president Pascal Spothelfer said the association doesn't have as much political leverage nationally as it does provincially. But he added that it's looking at how it can communicate to Ottawa the technology sector's concern over the tax structure on stock options.

“It certainly doesn't help the small technology companies who are competing for talent, not just among themselves locally, but also geographically on a broader scale,” said Spothelfer, referring to B.C.'s recruitment efforts in the Silicon Valley and other tech hubs. •

cgc@biv.com

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