

## Protest Unfair Tax Treatment by the Government of Canada and the Scandalous Favor to One Group of Canadians

*Do you know that you could be assessed at an effective tax rate of over 1000% by the CRA? That is not a typo, you could indeed end up paying at an effective tax rate of well over one thousand per cent in some circumstances due to a bizarre provision in the Canadian tax code. Read the shocking story of how the Canadian government continues to victimize many Canadians by imposing an outrageous tax on money they never made – even as it cut a rare private deal with some politically well-connected Canadians to exempt them from that kind of irrational assessment of tax on fictitious paper gains.*

**“MOST UNDER-REPORTED STORY OF THE YEAR”** – Don Martin, *National Post*, December 31 2007.

### **Issue**

This issue potentially affects Canadians whose employer companies offered employee share purchase or stock option plans. If a person exercises their stock options by buying shares in their employee company at a pre-determined price, the CRA considers that as a taxable event and attributes a tax liability to them based upon the difference between the “Fair Market Value” of the shares and the exercise price (the price at which shares are purchased). This difference is called “Employment Benefit”, and considered similar to a perk such as company-paid parking. Subsequently, when the shares are disposed, the difference between the sale value and the initial amount of Employment Benefit is considered regular Capital Gains or Losses.

This overly complex system creates a number of problems without offering any benefits. Both Employment Benefit and Capital Gains are taxed at the same rate, only the labels under which they fall are different. However, they differ in one critical way: if you suffer loss on your investment due to decline in the value of asset, CRA lets you offset the loss against your Capital Gains and you pay taxes only on the net value. However, the law in its infinite wisdom forgot to extend the same principle to Employment Benefit! There is no provision to offset loss of Employment Benefit for tax purposes.

This has the absurd effect of creating tax liability based on fictitious paper profit that you may or may not realize in the end. In fact, you could even lose money on your investment but the tax liability still stands. Many Canadians are quietly suffering from the double whammy of having lost a lot of money when markets crashed, and being stuck with a huge tax bill assessed on money they never made!!

### **Example**

For a number of such victims, the tech wreck of 2000 is a nightmare that continues to live on. Consider the plight of former employees of ACD Systems based in Victoria, BC. As the Financial Post reported in this [story](#), an employee exercised stock options at 25 cents when their shares were trading at \$12. This created a tax liability in the eyes of CRA based on a paper gain of \$11.75 per share (the difference between \$12 and \$0.25) which was deferred until the employee sells the shares. Subsequently, the share price collapsed but the employees remained stuck with the tax liability. Eventually, the shareholders of the

company decided to take the company private at 57 cents. This forced the employees to sell their shares at \$0.57.

So, in effect, this is what happened: employees of ACD Systems made  $\$0.57 - \$0.25 = \$0.32$  of real gains per share over more than 7 years. However, in the eyes of CRA, they are liable to pay tax as if they had gained \$11.75 per share! Imagine if you had to pay almost \$3 in tax for every \$0.32 of gain – it does not take a rocket scientist to figure out that even small numbers of shares in such a situation could bankrupt you pretty quickly. That is an effective tax rate of over 1000%! Of course, the CRA lets the person continue to carry forward a capital loss of  $\$12 - \$0.57 = \$11.43$  that may be used to offset future capital gains. But how will a person recover from a huge liability on money they never made in the first place that is far beyond their means, pay tax on the fictitious paper gains and then make enough capital gains that would eventually offset the loss?

If a person loses their savings of a lifetime and/or all assets, it is bizarre to expect that they will then make enough capital gains so that in the end, it will all even out. A person cannot make capital gains if they have no capital left to invest!

So what is happening now? Well, many Canadians are staring at potential financial ruin – all because of an absurd and unfair tax policy.

### **The Promised Reform That Turned Into a Private Deal**

Hope came for all victims of this issue when the Victoria Times Colonist broke a story in December 2006 that the government had granted tax relief on this issue. It seemed that the government had finally seen sense and was going to fix this bizarre provision in the tax code.

[“Stock fiasco victims to get tax refunds”](#) – Victoria Times Colonist, December 20, 2006.

Here’s what Victoria MP Gary Lunn said at that time: *“It took a change in government to get someone to listen, but the prime minister has come through and delivered tax relief. It’s not in the interest of government to tax people on money they never saw.”*

Right there in Victoria BC lived another group of people in a similar situation whose lives were messed up by the very same unfair tax policy. They were the former employees of SDL Optics whose company was bought out by the Ottawa-based tech high-flyer, JDS Uniphase. Unlike the rest of us, however, this group of former JDS Uniphase employees had a powerful friend in Gary Lunn, the MP from Victoria BC who is the Minister of Natural Resources in the Harper government.

If you ever suspected that some politically connected Canadians are treated better than others, then your suspicions are absolutely right in this case. It turns out that the Harper government had actually just worked out a rare and unprecedented private deal that was applicable just to that group of individuals! The Federal government issued a rare tax remission order to provide relief to them. However, the change of law for the rest of us promised by Minister Lunn never happened.

When the Canadian government finally notified this deal in the official Gazette in November 2007, all other victims of this issue felt like they had just been kicked in the head. Tax experts were outraged too. Jamie Golombek (CA, CPA, CFP, CLU, TEP, Vice-President, taxation and estate planning, at AIM



Trimark Investments in Toronto) wrote this in an article in the Victoria Times Colonist: *"It's outrageous, the biggest outrage in tax policy I've seen"*.

["JDS deal dangerous precedent, Ottawa told"](#) – Victoria Times Colonist, December 7, 2007.

*Please ask Minister Lunn: why is it in the interest of the government to tax us on money we never saw? Please ask PM Harper: where is the delivery of the tax relief for the rest of us suffering from this irrational tax policy?*

### **What Happens Now**

Except for that privileged group of ex-employees of JDS Uniphase, thousands of Canadians face financial ruin due to this absurd tax policy. The inaction of the Harper government in fixing it is particularly outrageous considering that the Tories' main campaign promise was to provide tax relief and rationalization. Was that promise meant only for a few Canadians and not the rest of us? All animals are equal, but some just happen to be more equal than others, don't they?

Even the CRA seems to see the light now. The Times Colonist [article](#) mentions that *"A similar warning came from Canada Revenue Agency Commissioner William Baker. In a memo to National Revenue Minister Gordon O'Connor, he warned that waiving taxes in this case was inconsistent with the laws and policies applied to all other Canadians."*

*Will Minister Gordon O'Connor or Minister Jim Flaherty act to reform the tax code in time to prevent financial ruin for decent, law-abiding Canadian taxpayers whose only crime is that they are just not as politically connected as others? Will the Harper government keep the promise made by MP Lunn in 2006? Or, Mr Harper, is it going to take another change in government before the tax code is applied rationally and fairly to all Canadians?*

### **About CFET**

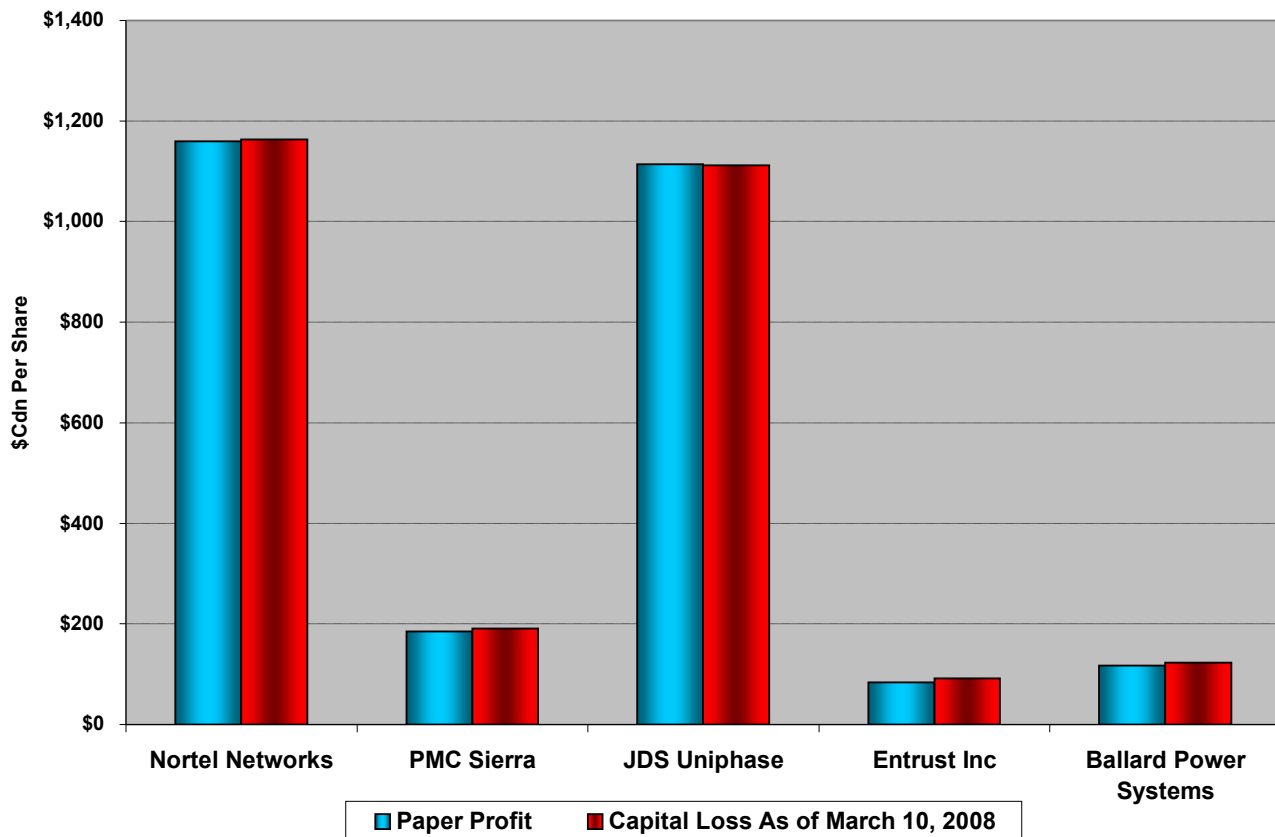
We are a rapidly growing group of Canadians united in our mission to have this draconian and irrational law fixed. Our members are currently based in Ottawa, Victoria, Vancouver and Calgary and we are hearing from Canadians from coast to coast. We are a strictly non-partisan group and do not support or oppose any political party or candidates. However, for many of our members, this is the most critical issue in their electoral considerations. We are in the process of launching a vigorous public campaign to spread awareness of this issue in an attempt to ensure that our fellow Canadians can save themselves from being victimized by unwittingly walking into this tax trap.

We are reaching out to Canadians from all walks of life regardless of their political affiliation. We are determined to protect the financial future of all Canadians from being destroyed by this irrational law. We firmly believe that it is fundamentally unfair, cruel and unjust to tax people on money they have never made. We are looking for support from every Canadian to uphold our faith and justifiable pride in our cherished traditions of compassion and fair play, and asking them to make their voices heard to the federal government on this issue.

## Illustration

We took a sample of five of the largest Canadian high-tech corporations and worked out indicative examples of the impact of this irrational tax on their employees. Many CFET members are current or former employees of these companies. Many of them find themselves in situations that are pretty similar to the following illustrations. The illustrations are based on an employee exercising 1000 shares (trading as of today, after splits) for an assumed \$10 exercise price per option on March 1, 2000 and holding them till March 10, 2008. Pricing data is from Yahoo Finance and Google Finance. Shares trading on US exchanges have been converted into Canadian Dollars based on the exchange rate on those two dates.

### Paper Profit and Capital Loss



This chart indicates that such an employee would have lost almost all of the paper profit from March 1, 2000 to March 10, 2008. In some cases, the capital loss is even bigger than the paper profit on exercise. The tax code does not allow offsetting the capital loss against the paper profit.

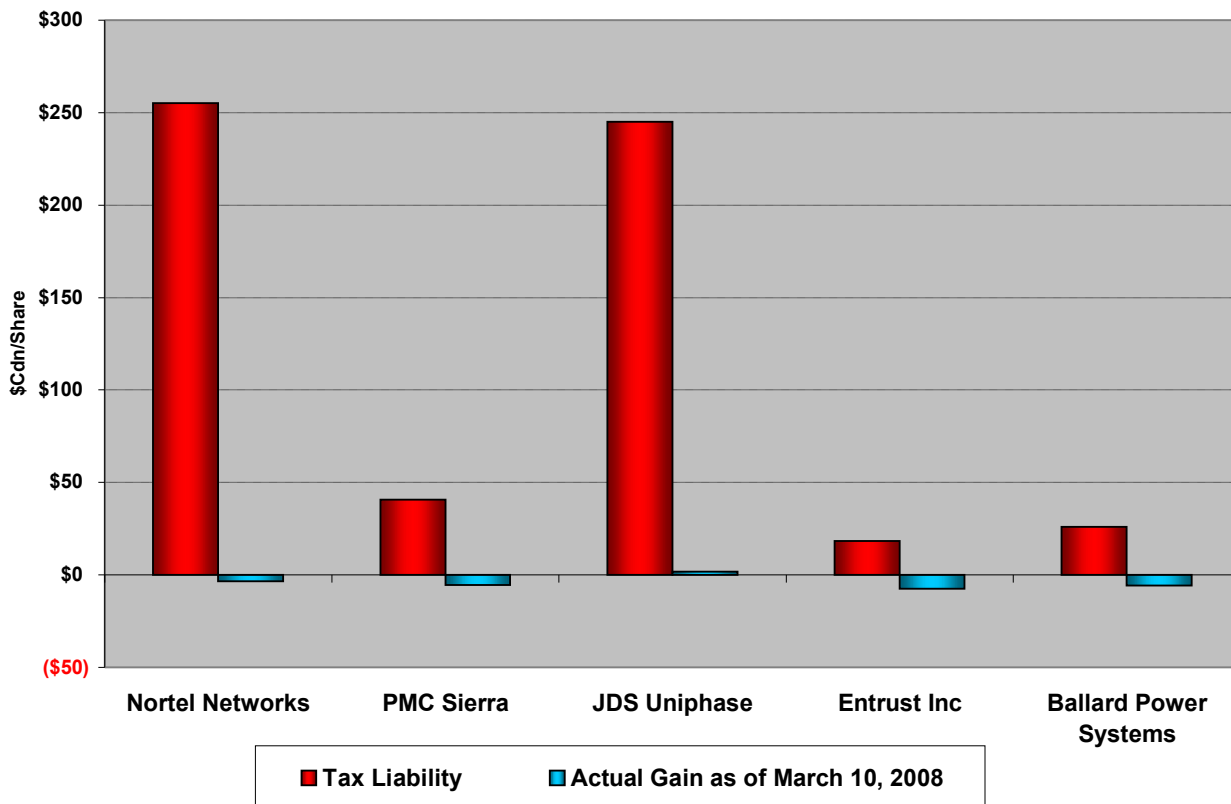
The next chart compares the tax liability imputed to paper profits and compares them with the actual gains such an employee would make if they were to sell their shares on March 10, 2008. In all cases, the tax liability is far higher than the actual gains. In fact, in most cases the employee would make less money per share than even the cost of exercising them! In such cases, the effective tax rate is infinite as the employee



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not only is liable to pay tax on fictitious paper gain, but their investment itself also lost money. Imagine having to pay huge taxes on an investment that lost money instead of making any.

### Tax Liability on Paper Profit vs Actual Gains Per Share



There is an incredible uniformity in response to CFET members explaining this chart to someone for the first time. As the realization sinks in that a Nortel employee could be liable to pay over \$250 per share when their investment over the last 8 years has actually lost money, the reaction ranges from disbelief, and shock to horror and anger. We keep hearing many reactions over and over: “No, this cannot be true in Canada”! “Wow, this is just insane”! “Why hasn’t the government fixed this yet”? “You mean CRA took someone’s house because they couldn’t pay taxes on a loser stock”? “That is just so unfair”.

These comments echo the frustration many of us feel. There is no way that a government could have intentionally laid out a tax trap such as this. Certainly, CFET members are not aware of this kind of taxation on stock options in any other country around the world. That such a law exists in a country that is routinely held up as a model and considered the best place to live in this world is a matter of tragedy.

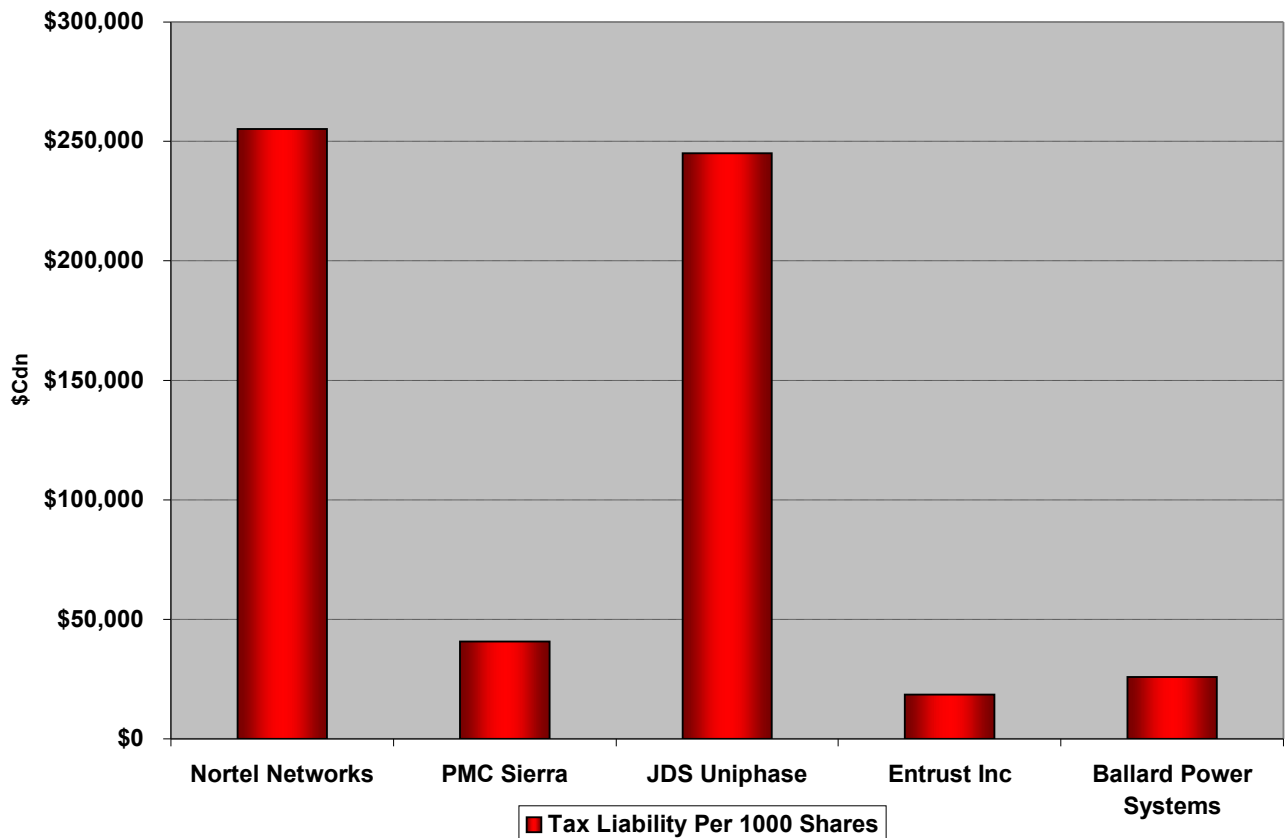
Compare this with how the US taxes stock options and the difference could not be starker. As we understand, the US considers exercising stock options to be a non-event from a tax perspective. Americans pay taxes only on the net gains, if any, when they sell shares acquired through exercising stock options. Furthermore, shares that are subject to restrictions are not taxed until they are free and clear. For more details, see FAQ #18.

Website: [www.cfet.ca](http://www.cfet.ca) E-mail: [inquire@cfet.ca](mailto:inquire@cfet.ca)



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### Tax Liability on Paper Gains Per 1000 Shares



The final chart indicates the amount of tax liability such an employee would incur per 1000 shares at an average rate of 22% for capital gains, which is the same rate applicable to Employment Benefit as well. Clearly, having to pay such huge amount of tax on income they never received in the first place would destroy the financial future of any middle-class Canadian family. This is the situation many of us are in.

## What Can You Do to Help?

1. If you are a victim of this bizarre issue in the tax code, please come forward and join us. You don't have to suffer in silence. Many of us are in the same unfortunate situation as you are. If you don't speak up then nobody is going to help you. If you are concerned with your privacy, you can choose not to share your name or contact information with us – just send us an email from a non-personal address. We can be reached at [inquiry@cfet.ca](mailto:inquiry@cfet.ca).
2. Please write, phone, fax or otherwise communicate with Ministers Gordon O'Connor and Jim Flaherty to protest against the unfair tax treatment and demand that the Harper government keep the promise made by Minister Lunn on behalf of PM Harper.
3. Please contact your local MP and remind them that you will consider this issue when you vote in the next election. There is a sample letter on our website that you can send to your MP.
4. If you are in the media, please help us get the word out. Talk to the victims, this is a real story of tragedy inflicted by an uncaring government and an obdurate bureaucracy. Hold ministers O'Connor and Flaherty accountable, because nobody else will. Hold PM Harper accountable for letting his subordinates fall asleep at the switch. Prominent national media outlets such as Macleans magazine, The National Post, The Vancouver Sun, Victoria Times Colonist, the I Channel and CBC have covered this issue in the past. Please add your voice to this.
5. If you are a politician, please help fix this issue right away. Financial future of many Canadians is at stake. As Don Cayo of the Vancouver Sun said very well, ["Change the law -- don't just mask the problem"](#) (Don Cayo, The Vancouver Sun, January 18, 2008.)
6. If you are an MP, please help introduce a bill in the Parliament to rectify the legislation.
7. Send your comments to let us know that Canadians are concerned about fairness in our society.
8. If you are part of any social or community group such as a professional association, alumni association, club, religious congregation, sport league, PTA, riding association etc, share this message with them. We need all the help we can get to spread this message and warn Canadians of potentially serious implications of participating in stock option or purchase plans they may be signing on to.
9. If you are part of the accounting, tax or legal profession, please help us work this issue with the government.
10. If you are a student, please discuss this issue with your friends and classmates. We need to spread awareness of this issue as an example of how our government could fail us in spite of the democratic checks and balances built into our system.
11. If you teach law, taxation, business, ethics or government related subjects, discuss this case with your students. Our plight is an example of how disastrous the unintended consequences of an overly complex and ill-designed law can be. Such issues fall through the cracks in our democratic system, and ruin the lives of many Canadians. Even one life ruined by such an irrational provision in the tax code is one too many. We continue to be held up as a model society around the world, and justifiably so. However, we need to do more to ensure that no law or government can ruin the lives of people by taxing them on income never earned.
12. Please warn your friends and family about this issue if they are participants in a stock options or purchase plan where they work. We urge you to do all you can to prevent more innocent Canadians from falling victim to this tax trap.

## **Frequently Asked Questions**

### **1. You knew/should have known the law. If you made a decision with full knowledge of the law, then you deserve to bear the consequences, why should the government do anything now?**

Many of us did not fully appreciate the complex combination of market, legal and taxation risks even though the law itself was known. The law is unnecessarily complex in this area and in many cases even professional advisors were not able to fully explain all the potential ramifications of our actions. Many of us were victims of bad professional advice. In many other cases, the situation was so complex that understanding and resolving even basic issues took many months even as the markets were going through a hugely volatile phase. In many cases, the implementation of the law is vague and complex due to lack of guidelines from CRA in areas such as the valuation of restricted shares. In other cases, people were misled by the federal budget of 2000 into believing that taxing of gains on stock option plans would be postponed to when the shares are sold rather than when options are exercised (see FAQ #17).

The key issues here are the proportionality of consequence for an action and the fundamental fairness in law. By and large, pretty well all we did was no different from what millions of Canadians do around the world every day: purchased stock. It's really as simple as that: there are no tax evasion schemes or complex tax structures or any of it. The companies we worked for allowed us to buy their own stock and that's all we did. However, the tax consequence of that one transaction is the equivalent of a virtual death penalty. In fact, it is worse because not only are we the victims ourselves but so are our friends and families. There are no winners here: even the Canadian government will end up getting less tax revenue from us over our lifetimes than they would have got otherwise because our professional lives are being destroyed. Is that a fair consequence for what is a fairly routine transaction? If a law produces such disproportionately drastic consequences for taxpayers, that is not reasonable by any standard.

Secondly, there is the issue of fundamental unjustness of the law. We all know that even if we make a fully conscious decision as adults of able mind to sign away our life into slavery, we cannot do that. The law will not recognize a contract that makes you sign away your personal freedom. However, right here in the Canadian tax code, we have a law that is capable of destroying your financial future by assessing tax on income never earned! Not being taxed on income never earned has to be one of the most fundamental principles of natural justice, but it is being violated for all of us. That we have such a law is in and of itself a matter of tragedy and shame for a great society like ours that prides itself on justice and fair play.

If this issue is not fixed, then a dangerous precedent will be set in which "no tax on income not earned" will no longer be a sacrosanct principle. Who knows how many other such provisions are lurking in the Canadian tax code? And who knows how many other such "technicalities" will be introduced in the law in future? And who knows how many other Canadians will become unwitting victims of such issues? Today, we are the victims but it could very well be you or your loved ones tomorrow. If this concerns you, then you must impress upon the government that we Canadians will not stand for any law that does not respect the principle of "no tax on income not earned".

### **2. Are you asking for a special treatment?**

No! We would like the government to keep its promise and change the law for all Canadians.

**3. You are just jealous of the ex-employees of JDS Uniphase. Those poor folks were in a unique situation and they suffered a lot, so they deserve special consideration by the government to fix this problem. Why should the government do anything more?**

We are not jealous of the JDS Uniphase folks. In fact, we are very happy for them and their families. They did suffer a harrowing ordeal. Nobody in a fair and compassionate society like ours deserves to suffer from an irrational tax code the way they did. We as Canadians are justifiably proud of our tradition of equality and justice for all, but it is clear that our government and institutions did not treat these folks in a particularly fair or just fashion. What we are pointing out is that their situation is neither unique nor rare, and many Canadian families are undergoing the same ordeal based on the same irrational provision in the tax code that assesses tax liability on fictitious paper gains.

Unfortunately, the government has not solved the root cause of this problem even as it worked out a temporary relief for this group of people. As a result, many other Canadians and their families have lived or will live through the same nightmare as the JDS Uniphase families did. Just as happened to them, many of us lost our jobs in the tech wreck too. Just as they were stuck with tax bills on money they never made, we are stuck with the same high tax bills on gains we never made. Many of us are staring at complete financial ruin – losing our savings of lifetimes and our houses – just as they did before the government wrote off their tax bills. We have no issue with the fact that their tax bills were written off, in fact that was the right and just thing to do. We only take issue with the manner in which the government chose to do it. Instead of fixing the bizarre technicality in the tax code that caused the problem and providing long overdue relief to all Canadians, the government just chose to deal with this as a one-off special deal for those people. That is outrageous and unfair.

We believe that the JDS Uniphase folks are decent, law-abiding taxpayers just as we are. In fact, it is very much possible that when they were struggling against the CRA bureaucracy and making their case, they perhaps wanted a remedy that was applied to all Canadians, not just to themselves. Minister Lunn said as much when he announced the “resolution” of the issue in 2006. Then why has the government still not acted to fix this irrational policy that will cause many other decent, law-abiding taxpayers the same kind of suffering? Does it really make sense to bankrupt people just so that the CRA can collect tax on a fictitious accounting profit that many of them never realized in the end? Must we continue to destroy the lives of many Canadians for such an irrational technicality? Bob Dylan was right when he sang “How many deaths will it take till we know, too many people have died?”

It is utterly tragic that the only lesson the government learnt from the 6 years of living nightmare that the JDS Uniphase families went through is that this a one-off problem only for that small group of Canadians. How many broken families and ruined futures will it take before the government acts on its promise to fix this mess? The horrific experience of the JDS Uniphase families is a stark example of how terrible the consequences of persisting with this policy are. The government must act immediately to keep its promise and stop this irrational tax liability on money never made from destroying the financial future of many other Canadian families.

**4. If you don't sell your shares, aren't you just taking market risk? Why should the government give you a break for speculation?**

Anyone who holds any non-cash asset is effectively speculating and they can make or lose money. Governments all around the world recognize this, and that is why Capital Gains tax is different from income tax. Fundamental principle of Capital Gains tax is that it must be on the net basis, not on an

imputed paper-profit. Capital Gains tax law around the world recognizes that investment in risky assets such as securities or real estate does not always work out and investments could lose money just as well as they could make gains.

We are asking that the same principle be applied to Employment Benefit. If market risk reduces the value of the security, it is only fair that the loss in market value be offset against the gain. Otherwise you end up in an absurd situation where you may be liable to pay almost \$3 tax on almost \$0.30 of gain, as happened to the ACD Systems folks.

### **5. Still, why didn't you sell your shares? Why should the government give you a break now?**

Shares obtained from exercising stock options can be subject to many restrictions. In many cases, people did not have full control over the shares. For example, many employees were subject to insider-trading restrictions which prevented them from selling shares for months at a time. In other cases, there were restrictions on when the employees would get access to their shares. For example, some stock option plans gave ownership of shares to employees only over a long period of time of up to four or five years after the exercising of options. If those people did not have ownership of the shares, how could they sell? There are also other restrictions against hedging and short-selling by employees that prevented people from selling their shares or locking in their gains. Some people made investment decisions that seemed reasonable at that time, but did not work out. Many others just could not judge all the risks in complex situations because they did not know better, had no experience with financial markets, received bad advice or were not market savvy.

We are not asking the government to give us a break. We are merely asking the government that we be taxed only on the actual gains we may have actually made, not on fictitious paper-profits.

### **6. You sound like a spoilt dot-com millionaire, don't you deserve what's happening to you?**

Actually, many of us are regular middle class Canadians with families to support and mortgages to pay. Many of us are staring at complete financial ruin. If we had the money, we would not have any trouble paying our taxes, would we? Far from being dot com millionaires, in fact, many of us are losing our savings of lifetime in our middle ages. We were caught in the perfect storm of living through once-in-a-lifetime behavior of stock markets combined with a bizarre and irrational provision in the Canadian tax code that was not suitable for the kind of volatile market we saw in late nineties. Many of us did not have the capability, experience or even good advice to deal with this unique set of circumstances. Do we really deserve the destruction of our financial futures to pay tax on the money we never made?

### **7. Isn't this a violation of the Taxpayer's Bill of Rights?**

Yes, we believe that it is. The following two rights articulated in the [Taxpayers' Bill of Rights](#) are violated in this situation:

#### **5. You have the right to be treated professionally, courteously, and fairly.**

You can expect we will treat you courteously and with consideration at all times, including when we request information or arrange interviews and audits. Integrity, professionalism, respect and cooperation are our core values and reflect our commitment to giving you the best possible service. You can also expect us to listen to you, take your circumstances into account, and treat you fairly to make fair and impartial decisions in accordance with the law. We will explain our decision and inform you about your rights and obligations with respect to that decision.

### **8. You have the right to have the law applied consistently.**

You can expect us to apply the law consistently so everyone gets their entitlements and pays the right amount. We will take your particular circumstances into account to the extent that the legislation we administer allows us to do so.

Clearly, we are neither treated fairly nor is the law being applied consistently.

### **8. If your rights under the Taxpayers' Bill of Rights are violated, why don't you appeal to the Ombudsman?**

We welcome the appointment of the Ombudsman, and are cautiously optimistic about the effectiveness of this office. However, we have serious concerns about how much real authority the Ombudsman's office has been vested with in dealing with cases such as ours. There are significant questions about the real ability of oversight this office may or may not have over CRA.

First of all, the mandate of the Ombudsman's office as described on the CRA's website [here](#) indicates that the Ombudsman is responsible to enforce only a subsection of the provisions outlined in the Taxpayers' Bill of Rights. One critical right that is very conspicuous by its absence from this list is #8 on the Taxpayers' Bill of Rights, "**You have the right to have the law applied consistently**". Who will enforce this right?

Secondly, the authority of the Ombudsman's office is further restricted due to significant [limitations](#) imposed on it. For example, the Ombudsman cannot direct the CRA to take action nor can the Ombudsman discipline any person for their actions or behavior. How, then, can the taxpayer reasonably expect the Ombudsman to enforce the right of expecting the CRA to be accountable?

Thirdly, it is not clear that the Ombudsman can stop the CRA from enforcing a provision in the tax code that is irrational or unfair. In fact, considering that the Ombudsman is not even allowed to direct the CRA to do anything, it is not obvious to us if there is any value at all in going through the Ombudsman's office regardless of the outcome of that process.

This lack of authority is a serious issue that should be of concern to all taxpayers. The tagline for the Ombudsman's office is "Upholding your [service](#) rights". A careful reading of the Ombudsman's mandate shows that its primary role has been reduced to reviewing service complaints that have gone through CRA's existing appeals processes. This falls very short of the original promise of the new office as an external oversight authority empowered to enforce the entire Taxpayers' Bill of Rights.

It seems that all that the Harper government wanted to do was get good PR from proclaiming the Taxpayers' Bill of Rights and establishment of the Ombudsman's office without having either of them become truly effective. Even after the establishment of the Ombudsman's office, the CRA remains the police, prosecutor, judge and jury in all tax matters without any effective external oversight of potential abuse of its powers that may violate the Taxpayers' Bill of Rights. What is the value in having the Taxpayers' Bill of Rights if these rights are not backed by an agency external to the CRA being empowered to enforce them?



As Jonathan Chevreau of the National Post says in his commentary on the Taxpayers' Bill of Rights ("[So much for tax fairness](#)", May 29, 2007) "Other measures seem similarly designed to make the CRA's life easier as opposed to the lives of those who contribute to its coffers."

### **9. Can you not fight this in the courts?**

Surprisingly enough, the courts in the past have upheld special private tax deals done by the government and refused to extend the fairness principle to all taxpayers. Here's an article on this issue from the website of a law firm, Gowlings:

#### [The Tax Man Giveth? CRA Allows Substantial Stock Option Tax Break](#)

The article says: "Most taxpayers would consider the CRA's stance on this issue to be patently unfair. However, absent further political pressure, or legislative amendment, taxpayers would probably be surprised to learn that Canadian courts have generally refused to recognize a duty of consistency on the part of the CRA in the course of administering and enforcing the Income Tax Act, and have expressly held that the CRA has no positive legal obligation to treat similarly situated taxpayers consistently."

### **10. What are the long-term effects of this issue on the Canadian economy?**

An average Canadian family paid approximately \$27,000 in all taxes in 2003 according to this [research](#). Assuming the family pays at this rate for 40 years on average, that represents over \$1 million in taxes. Clearly, those families where wage earners joined the work force earlier than others are likely to be paying more than the average. So assuming that bulk of these taxes – say 70% - are paid in prime earning years – say the latter half of working life, or 20 years – an average Canadian family could contribute almost \$700,000 in taxes in their prime productive years.

Now consider what happens if those families go through harrowing ordeal due to this irrational policy in their prime earning years. It's likely that the wage earners would be unable to earn according to their productive capacity. Their economic and emotional well-being would be destroyed and they could succumb to physical and mental health issues. Their families would suffer terribly and impose high social costs to consume more tax dollars in support services such as welfare and child benefits. A family that would have been a net contributor to the tax base would instead likely turn into a net consumer if they suffer the loss of their lifetime savings and assets just to pay taxes on money they may never have made.

The pernicious effect of this tax code is to effectively jeopardize almost \$700,000 of tax revenue the economy could be gaining from every victim's family. It could take an otherwise productive, tax paying family, and turn them into perhaps a net cost to the society. Even if only 1000 families suffered this fate, the economy could lose as much as \$700 million in lost taxes! This is a lose-lose situation for all Canadians.

Solving this problem for current and future victims will enable them to focus on applying their productive energy to contribute to the growth of the Canadian economy and the tax base. Many current victims are mid-career professionals who are reaching a highly productive phase in their lives and will likely contribute significantly to the tax revenues over the next few decades. We are happy and proud as Canadian tax payers with the prospect of doing so. However, we cannot do that if our personal and professional lives are destroyed by this bizarre technicality in the tax code.

There is also a bigger issue in motivating people to join the high-tech work force or participate in ownership of stocks in their employer's company. High-tech industry depends upon participation of their work force in the company's equity to motivate people to join an industry that is fundamentally riskier than many others. In fact governments around the world are trying to simplify laws regarding stock options and capital gains to encourage participating in ownership of high-tech ventures by employees. Canada's competitiveness in attracting skilled workforce could be severely compromised if the next generation of workers is scared to join the industry due to such laws.

**11. You sound politically motivated. Are you doing this because you are against the Tories/Liberals/NDP/Minister Lunn/PM Harper?**

We are absolutely a non-partisan group of people. In fact, our lives have been consumed by this nightmare that we've been living through for many years. Politics is the last thing on our mind. We are appealing to anyone and everyone in public service who may be in a position to help us. We are reaching out to all parties, media outlets, organizations, etc – really, anyone who'd listen – irrespective of their political leanings.

Similarly, we are not political supporters or opponents of Minister Lunn or PM Harper. In fact, we believe that Minister Lunn has done a great job of representing some of his constituents to the government in resolving this issue. However, we are disappointed that Minister Lunn ignored the problem for the rest of us, including some others living in his own constituency who are affected by the same issue! It is extremely disappointing to see that MP Lunn chose to represent the narrow interests of a small group rather than the interests of all Canadians as would be expected of a member of the national Parliament. The government then, quite disturbingly, treated this as a one-off case instead of solving the root cause of the problem. It is simply incomprehensible why the MP Lunn and the federal government acted in such fashion. After the effort that Minister Lunn has put into this issue for some of his constituents, we just want the government to follow through and fix this bizarre tax trap for all Canadians.

**12. It seems that your rights under the Charter could be violated. Why don't you launch a Charter challenge in the Supreme Court?**

We believe that at least two of our charter rights – the right to be equal before the law and under the law and the right to equal protection and benefit of the law, and the right of not being subjected to any cruel or unusual treatment or punishment are being violated here. Unfortunately, we do not have the resources to take on such a challenge. However, if we can get support from Canadians concerned about this potential violation of our rights to support us in such a challenge, we may consider it. Talk to us!

**13. What changes need to be made to avoid creating tax liability on fictitious paper profits?**

The government has a number of easy options to fix this.

1. The gain on exercising stock options could be treated as a capital gain instead of employment benefit. Tax payment on the gain can be deferred until the shares are finally disposed at which time tax would be payable on the net capital gain or loss based on the price of disposition.
2. The government could allow capital loss to be offset against employment benefit out of stock option exercise. This will ensure that the fictitious paper gain counted under employment benefit can be adjusted by the subsequent losses due to reduction in the value of shares.

**14. Wouldn't these changes allow people to get away with not paying their fair share of taxes?**

No, everyone will still continue to pay full taxes on any gains they make on stock options at the rate of capital gains inclusion under the proposed reforms as well. All the reform will do is prevent taxing people on fictitious paper profits even after the source of that profit has drastically declined in value or when the person does not end up realizing those gains. This is the fundamental unjustness of the current system: taxing people on money they may never have made.

**15. Is there a precedent for the kind of reform you are proposing?**

Yes, we understand that the CRA allows net capital losses to be used for offsetting other income in assessing the estate of a deceased person for calculating the tax liability of the departed. "Method A" of applying net capital losses to the deceased person's liability indicates that "You may be able to use some of the resulting amount to reduce other income on the final return, the return for the year before the year of death, or both returns." It appears that if a victim of this issue were to die then their estate would be able to get relief.

While this provision is helpful, it begs the question as to why this cannot be extended to us during our lifetime. After all, we could contribute much more to the society in tax revenue and productivity if our financial lives were not to be ruined by this irrational law.

**16. In that case, why don't you just carry on with life? After all, your liability is deferred until the shares are disposed. Just don't sell those shares.**

That is exactly what many of us are living through right now. However, a major problem with such postponement of the problem is that it is not always in our hands to decide when the disposal takes place. The deferral could be discontinued even if we do not voluntarily sell our shares in many situations. For example, a majority of shareholders decided to take ACD Systems private in a transaction that forced all shareholders to sell their stock for \$0.57 in cash. This triggered the lapse of deferral.

The law does not account for the possibility of such involuntary disposal. Is it really fair then to expect us to live with this issue all our lives knowing that the liability could be triggered any time due to situations beyond our control? At the very least, the law needs to make some provision for the fact that small and minority shareholders lives could be severely affected by involuntary disposal of shares.

**17. Didn't the Canadian government already give a break on stock options in the federal budget of 2000?**

Here is what the Federal Budget of 2000 [said](#):

"To ensure continued growth and job creation in a global economy that is increasingly knowledge-based, the Plan will:

reduce corporate tax rates to 21 per cent from 28 per cent within five years for the highest taxed business sectors, such as high-technology, beginning with a drop to 27 per cent effective January 1, 2001;

reduce the corporate tax rate to 21 per cent from 28 per cent on small business income between \$200,000 and \$300,000 effective January 1, 2001;

lower capital gains taxes by reducing the amount of capital gains included in income for tax purposes from three-quarters to two-thirds;

**postpone the taxation of gains on shares acquired under qualifying stock options to when shares are sold, rather than when the options are exercised; and**

allow a tax-free rollover of capital gains on qualified investments from one small business to another.”

It is clearly spelt out in the federal budget of 2000 that the government policy is to postpone taxing gains on stock options to when the shares are sold, not when the options are exercised. According to this very clearly stated policy, exercising share options should be a non-event and any tax liability must arise only when shares are sold subsequent to the exercise. Unfortunately, the legislation meant to carry out this policy laid out in the budget does not implement it in spirit. It creates a tax liability on a fictitious paper gain which is treated separately from the capital gains tax. It makes no sense to create such an intermediate liability when the government’s intention was to tax stock option gains only when the shares are sold, not when they are exercised. It makes even less sense that subsequent loss in capital is not allowed to be offset against this fictitious paper gain.

In fact, many of us took the decision to exercise our options in the year 2000 after reading this policy in the federal budget. We were then shocked to discover that the legislation had not lived up to the stated policy of the government of the day.

It’s been 8 years since this faulty legislation was passed. A group of people has been granted relief from the unfair impact of this irrational legislation. Ministers in the federal cabinet are aware of this issue. There is a Conservative government in power whose major campaign promise was tax relief and rationalization. Why is the federal government asleep at the switch while the financial future of many Canadians is being destroyed?

### **18. Didn’t the US have a similar problem in the past? What did they do?**

The US had a similar problem due to their “Alternate Minimum Tax” (AMT) legislation, which resulted in a number of Americans getting taxed on phantom paper gains. Many Americans suffered the devastating consequences of an abusive and irrational tax provision similar to that on the books in Canada. A couple of victims of the unfair AMT legislation even [committed suicide](#).

The American Congress finally acted and fixed the AMT legislation to provide relief to the American taxpayer. Over the last few years, the US Congress has passed successive legislation that alleviates the impact of the unfair effect of the AMT. The legislative reform found bipartisan support from both sides of the aisle in the US Congress. More details on the evolution of stock option taxation legislation in the US and AMT can be found [here](#) and [here](#).

### **19. How does the US tax stock options now?**

We understand that the US tax code does not have these problems. As we understand, the US considers exercising stock options to be a non-event from a taxation perspective. The US considers only the sale of stock acquired through the exercise to be a taxable event. On selling the stock, all capital loss is offset



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against all capital gains and the tax is payable only on the net gains, if any. If the sale price of the shares is below the exercise price, then the taxpayer gets a net capital loss and no tax is payable. This is exactly how it should be. Under the US system, a tax payer only pays taxes if the investment makes any gains at all. It does not create any liability on phantom paper profits.

We quote a [publication](#) from the IRS website for two types of statutory options, ISO (Incentive Stock Options) and ESPP (Employee Share Purchase Plans):

**“Grant of option.** If you receive a statutory stock option, do not include any amount in your income when the option is granted.

**Exercise of option.** If you exercise a statutory stock option, do not include any amount in income when you exercise the option.

**Sale of the stock.** You have taxable income or a deductible loss when you sell the stock that you bought by exercising the option. Your income or loss is the difference between the amount you paid for the stock (the option price) and the amount you receive when you sell it. You generally treat this amount as capital gain or loss and report it on Schedule D (Form 1040) for the year of the sale.”

Not only does the US system treat the taxpayer much more fairly on stock options, it is also much less complex compared to ours. The US system clearly does not ruin the financial future of its work force due to taxation of phantom profits. The simplicity of stock option taxation also makes the US a more attractive jurisdiction for investment.

As CFET has realized, there are no winners in the current situation under our tax code. Employees lose due to taxation on phantom profits. Industry loses investment dollars due to the complexity of the current tax regime. The government loses tax revenue as productive families are financially ruined. Highly educated new workers are discouraged from joining the technology industry as they hear stories of risks associated with working for small technology companies that offer “sweat equity” in the form of stock options. Canadian society loses in the long run as our technology sector becomes less competitive compared to the US and other countries. There is an immediate need to fix this flawed legislation and we call upon the government to act on it without any further delay.

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