ONTARIO ENERGY BOARD

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, Sch.B, as amended;

AND IN THE MATTER OF an Application by Enbridge Gas Distribution Inc. pursuant to the *Ontario Energy Board Act* for an Order or Orders approving the clearance or disposition of amounts recorded in certain deferral or variance accounts.

FINAL ARGUMENT
ON BEHALF OF THE
SCHOOL ENERGY COALITION

August 27, 2010

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1 GENERAL COMMENTS

1.1 *Introduction*

1.1.1 On April 16, 2010 Enbridge Gas Distribution Inc. filed an application for clearance of certain deferral and variance accounts. The clearance included the calculation of the Earnings-Sharing Mechanism (ESM), which in turn required assessment of whether the net earnings for regulatory purposes had been calculated correctly.

1.1.2 The parties reached a comprehensive settlement on all issues except one. The Settlement Agreement was approved by the Board on July 8, 2010.

1.1.3 The remaining issue is the proper amount of "stock-based compensation" that should be deducted in calculating earnings subject to the ESM. Pursuant to Procedural Order #2, additional evidence was filed, interrogatories were asked and answered and Enbridge filed Argument in Chief on that issue on August 20, 2010.

1.1.4 This is the Final Argument, on that one remaining unsettled issue, filed on behalf of the School Energy Coalition.

1.2 *Summary of Submissions*

1.2.1 In these submissions, we conclude that the three different kinds of stock-based compensation – ISOs, RSUs, and PSUs, should be treated differently for regulatory purposes:

(a) ***ISOs*** should be treated as regulatory expenses when they are exercised, and at a valuation that considers the accounting rules, the actual benefit conferred on the employee, and the tax impact on the utility.

(b) ***RSUs*** are deferred bonuses, not stock options, and should be considered regulatory expenses when they are paid.

(c) ***PSUs*** are deferred incentive bonuses, not stock options. Because they only incent actions that benefit the parent company, and not the utility or its ratepayers, they should not be treated as expenses for regulatory purposes.

1.2.2 The effect on earnings sharing for 2009 would be that no amount of stock-based compensation would be included, for three different reasons. For ISOs, the amount of the exercised options would be less than or equal to the amounts already accrued in prior years for those same options. For RSUs, none would have been paid to employees in 2009, as the first were granted only in 2007. For PSUs, we propose that they not be regulatory expenses at all.

2 APPROACH TO ANALYSIS

2.1 *Different Kinds of Stock-Based Compensation*

2.1.1 In EB-2006-0034 the Board considered whether Enbridge should be allowed to include the cost of stock options in determining revenue requirement. In pages 4-6 of that decision, the Board reviewed the nature of stock options as a type of compensation, and focused on the question of whether they should be treated as an expense even though there was no cash outlay, for example saying [page 5]:

"The issue here is a narrower one: whether a non-cash expense qualifies as a regulatory expense for ratemaking purposes."

2.1.2 We note that the Board's consideration was limited to stock options, one of the three types of "stock-based compensation". We also note that the Board did not consider the timing of the expense, as the issue was whether, not when, stock option expenses would be included in revenue requirement.

2.1.3 In this proceeding, there are three types of "stock-based compensation". One is the traditional stock options, in which employees are given an actual right to purchase shares of a company at a particular point in time. The other two, which comprise the bulk of the amount claimed as an expense, are restricted stock units and performance stock units. As we discuss in more detail later, these two mechanisms are not stock at all. No shares are issued nor is there any right to any shares. Rather, they are simply deferred cash bonuses in which the stock price is part of the formula to calculate the amount of the bonus.

2.1.4 These mechanisms, often called "phantom stock plans", were not considered by the Board in EB-2006-0034. To the best of our knowledge, this proceeding is the first time the Board is faced with considering when, and to what extent, these cash incentive plans should be recognized as expenses for regulatory purposes..

2.2 *Nature and Timing of the Expense*

2.2.1 The Board has determined, in EB-2006-0034, that actual stock options are an expense notwithstanding that there is no cash outlay by Enbridge. We do not believe that issue is any longer in play, and we do not believe it is open to us to argue, as we have done in the past, that stock options should not be considered an expense.

2.2.2 The Board, in Procedural Order #2, has made clear that the amount that should be included as an expense in 2009 for each of these types of compensation is in issue. This raises two questions. First, what is the **absolute amount** that should be considered an expense for each of these three compensation mechanisms? Second, **when** should that amount be expensed for regulatory purposes?

2.2.3 In the following sections, we look at each of the three in turn, and suggest considerations that we believe the Board should take into account in answering these questions.

2.3 *Factors to Consider*

2.3.1 ***CGAAP and IFRS.*** The Applicant has proposed to include these amounts as expenses based on accounting standards, currently CGAAP. We presume that later that will be changed to IFRS based accounting rules, but it is not expected that will result in material changes.

2.3.2 The accounting rules can apply to both how much expense is recognized, and when it is recognized. While there is a certain amount of judgment involved, in general accounting rules seek to ensure that all present and future costs of an enterprise are recognized for financial presentation purposes as soon as they are known. This is the principle of conservatism. Therefore, the accounting rules require that a company recognize an expense as soon as the commitment to make a future payment is made.

2.3.3 Regulatory rules do not always follow the accounting rules, because the regulator has to be concerned with the appropriate point at which an expense should be recoverable from ratepayers in rates. This means that there are numerous circumstances in which regulatory recovery is timed later than financial statement recognition, and/or is of a different amount. Factors that the Board uses to determine timing and amount are things like matching the cost to the ratepayer benefit achieved, and deferring recovery until the amount to be recovered can be calculated with reasonable certainty.

2.3.4 In the analysis that follows we conclude that some of the SBC expenses proposed by Enbridge based on the accounting rules should be given different regulatory treatment for those reasons.

2.3.5 ***Tax Treatment***. Generally, the Board is not concerned with the tax treatment of an expense when it determines regulatory treatment. However, the various types of stock-based compensation have been considered thoroughly by the drafters of Canada's taxing statutes, because they have the same issues relating to amount and timing that the Board faces.

2.3.6 In our submission, the conclusions reached by the government with respect to taxation of stock-based compensation inform the Board with respect to those issues of timing and amount. In the remaining sections we will consider those conclusions.

2.3.7 ***Other Factors.*** For some of the three types of stock-based compensation used by Enbridge, there are specific aspects of the calculation that we believe should be reviewed and altered by the Board.

2.3.8 ***Results.*** After reviewing each of the three types of SBC, we then propose principles that we believe the Board should apply in determining when and in what amounts SBC should be treated as a cost of service.

3 INCENTIVE STOCK OPTIONS

3.1 *Description of Incentive Stock Options (ISOs)*

3.1.1 The traditional form of stock based compensation involves giving an employee a right to purchase shares of a company – usually either the employer or a related company – at a predetermined price at a specific time in the future. Typically the right vests over some period of time, and then expires at a subsequent time after that.

3.1.2 For example, a typical stock option would include a "grant" today, in which the employee gets the right to purchase 1,000 shares of the employer's stock, at a "strike price" equal to today's value of the stock on the stock market, e.g. $50.00. The right to purchase is not immediate. Usually it vests over time, and the standard is four year vesting, i.e. after one year, the right to purchase 250 shares can be exercised, and after two years up to 500 can be exercised, etc. Usually there is also an expiry date, e.g. ten years after the grant, or sixty days after ceasing to be an employee, whichever first occurs. If the price goes up to $100 after four years, the employee can purchase the shares for $50,000 (strike price), then immediately sell them for $100,000 (market price), and enjoy a $50,000 benefit without tying up any money in the meantime. Conversely, if the stock price goes down, the employee does nothing, and has not lost anything. (The employee can also buy the shares under the option, but then hold on to them as an investment, adding a further aspect of stock price risk and reward.)

3.1.3 Since stock options are usually granted at a strike price equal to market price at the time , one could argue that there is no value. The employee only has the right to purchase at the same price as he or she could buy on the market. That argument fails, however, because having a guaranteed right to purchase at today's price for a period of time allows the option holder to get a benefit when the market price does exceed the strike price.

3.1.4 The economic value of the option is the employee's ability to participate in the rise in value of the stock, if any, without having to expend funds at the outset, and without taking the risk of a drop in its value. It is an asymmetrical, zero-cost "investment". The higher the likelihood that the stock price will vary during the period the option can be exercised, the more the right to a fixed price purchase is worth. The standard method of calculating that value on Day 1 is called Black-Scholes, which is essentially a formula based on the stock's volatility (and for which Myron Scholes was awarded the Nobel Prize). The International Accounting Standards Board (IASB) has since 2006 required such a valuation (using Black-Scholes or, in some cases, a different approach called a binomial model, seldom used in Canada) and treatment of the resulting value as a compensation expense in the year of an option's grant or vesting.

3.1.5 There are thus five key points in time here:

(a) First, there is the time that the option is granted. Although there is a value for accounting purposes at that time, the option has no immediate value to the employee, because it cannot be exercised (it has not yet vested), and the strike price is no different from the market price.

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(b) Second, there is the time of vesting. From the employee's point of view, this is the first time that he or she can convert the "right" into cash. There is a basic value here equal to any excess of market price over strike price, but there is also a continuing future value because the employee can defer exercise for some period.

(c) Third, there is the time the option is exercised. At that point, there is no longer any future value, but to the extent that the market price was higher than the strike price, the employee has realized that difference by purchasing the stock at a discount. Conventional theory is that any change in value after that is unrelated to the stock option. The employee could realize the gain at that time. If he or she instead chooses to hold onto the stock, that is a separate investment decision, and any gain or loss that results after that is related only to that investment (hold) decision.

(d) Fourth, there is the time that the shares are sold. As noted above, any value different from the value at the time of exercise is unrelated to the option, and related only to the decision to hold onto the stock.

(e) Fifth, there is the point in time that the option expires unexercised. This is called "forfeiture", and whatever value the option had prior to that time is extinguished..

3.1.6 Enbridge follows the rules of CGAAP [SEC #9], which mandate that the option is valued at the time it is granted (using Black-Scholes), and there is no subsequent accounting entry.

3.1.7 By way of example, suppose the hypothetical employee earlier was granted their 1,000 options at $50 in 2007. Black-Scholes would be used to calculate the value of the options, say $8,000. The employee actually has no immediate value, but the future value is recognized as an expense for accounting purposes immediately. (In the case of Enbridge, this expense is fixed at that time, but recognized in each of the four years in which the option vests. i.e. $2,000 per year, which is the most common accounting approach in Canada.)

3.1.8 In 2008, 250 options vest. If at that time the market price is $60, the immediate value to the employee is $10 per vested share, or $2,500, but the real value is that plus an additional amount for the future right to purchase, likely the same $8,000 or more. If at that time the market price is $40, there is no immediate value, but there is still a future value, which is probably less than $8,000. Regardless of these changes in value, there is no adjustment to the expense for accounting purposes.

3.1.9 If the employee purchases the shares in 2011, when the market price is $75 per share, the value of the option is crystallized at $25 per share, producing a $25,000 benefit. There is no adjustment to the expense for accounting purposes. Although the employee will usually sell fairly quickly, taking the cash, the employee can instead make an investment decision to tie up $75,000 of their money in the shares.

3.1.10 Often, however, the market price does not go up, so the option is not exercised. Where that is the case (i.e. the option is said to be "under water"), sooner or later it will expire. Again, there is no adjustment for accounting purposes. The original $8,000 expense was incurred, but never actually paid out in any direct or indirect way.

3.1.11 As this example demonstrates, the accounting treatment of stock options is fixed and bears no resemblance to when a benefit is delivered to, and realized by, the employee, if at all. The expense is $2,000 per year for four years in this example, but the actual realized benefit will not be that amount. It will, instead, be anywhere from zero to a substantially higher amount, and will always occur later than the accounting accrual takes place.

3.2 ***<u>Tax Treatment</u>***

3.2.1 Tax treatment of stock options is a topic that has been widely discussed in the tax literature. The current tax treatment, which is correctly summarized by Enbridge in SEC #9, follows in essence the following rules:

(a) The employer has no tax deduction of any sort at any time with respect to stock options, because the employer does not actually make any payment of compensation to the employee. For tax purposes, the employer is not considered to have a "cost".

(b) No amount is included in an employee's income when the option is granted, nor when it vests. The basic rule is that when the option is exercised, the difference between the strike price and the market price is a taxable benefit, half of which is included in income in that year.

(c) A special rule – a type of tax expenditure or preference - allows employees to elect to defer taxation until they sell the shares. Aside from that special rule, the taxation at the time of sale follows the "new investment decision" concept described above, i.e. the employee is treated as effectively "buying" the share at actual cost, plus the taxable benefit at the time the hold decision was made.

3.2.2 The tax treatment therefore expresses a conclusion that the appropriate time to both value and recognize the stock option for tax purposes is the time of exercise. It also taxes the employee, but does not provide a deduction to the employer, as the stock option is not considered to be an expense for tax purposes.

3.2.3 We note that, while Enbridge follows accounting rules and values the option at the time of grant (i.e. step 1), then expenses it as vesting occurs (step 2), both of those take place earlier than the tax rules provide (step 3 in both cases).

3.3 ***Other Factors***

3.3.1 We note that ISOs are not deductible for tax purposes by Enbridge Gas Distribution [SEC #9, p. 5]. This creates the anomalous situation in which the "payment" by Enbridge of this compensation (which does not actually occur) is recoverable from ratepayers in rates (or included in the calculation of the ESM) as if it were cash compensation, but the grossed-up tax recovery from ratepayers is also increased due to the non-deductibility of this type of compensation.

3.3.2 At a 30% tax rate, the cost of $1 million of ISO expense to the ratepayers is the $1 million of OM&A, plus $428,000 representing the grossed-up tax cost associated with non-deductibility. Put another way, $1.43 million of salaries and wages has the same rate impact as $1 million of ISOs.

4 RESTRICTED STOCK UNITS

4.1 *Description of Restricted Stock Units (RSUs)*

4.1.1 Restricted Stock Units are not actually stock at all. They are a type of employee incentive bonus, in which the payment is deferred until a future date, and is calculated at that time based in whole or in part on the value of the parent company's publicly-traded shares at the time of payment. In Enbridge's case, they are payable 35 months after grant, and are not vested until that time. If an employee leaves the company before payment, the RSUs are not payable.

4.1.2 The distinction between an ISO and an RSU is important, because the essence of an RSU is not investment in the company's stock. Rather, it is retention of employees through deferral of their compensation until a later date. The addition of stock price as a calculation variable is an added incentive feature (primarily benefiting the employer by aligning employee outcomes to shareholder outcomes), but it is not at the heart of the structure.

4.1.3 The use of this kind of structure, called long term incentive compensation (LTIC), has been expanding in recent years, in part because of the 2006 changes to the IASB rules requiring expensing of stock options [see Tax Executives Institute Federal Budget Submissions, 2009, a copy of which is attached to these submissions]. In essence, stock options were better for the employer when they did not have to be treated as an expense, but just referred to in the notes. Once they had to be on the income statement, employers went instead to RSUs and their kin, since they would also get a tax deduction and avoid issuing new shares.

4.1.4 Once it is clear that the essence of an RSU is a deferred bonus, not an investment in the company's stock, it is in our submission easier to understand the appropriate regulatory treatment.

4.1.5 For accounting purposes, Enbridge values each RSU quarterly and expenses the net change in the overall value (accounting for expired and forfeited RSUs at the same time). However, we note that because of how RCAM is calculated, quarterly adjustments do not flow through from EI to EGD [SEC #10, p. 3]. It is not clear to us based on the evidence before the Board how the EI accounting amounts and the RCAM amounts are trued up so that EGD's ongoing expense reflects changes in the value of the accrued bonuses, and the effect of expiries and forfeitures.

4.2 *Tax Treatment*

4.2.1 Section 78(4) of the Income Tax Act, Canada, provides that deferred compensation is not deductible to the employer in the year it is declared unless it is paid within 180 days of the end of the year. The wording of the section is as follows:

> *(4) Where an amount in respect of a taxpayer's expense that is a superannuation or pension benefit, a retiring allowance, salary, wages or other remuneration (other than reasonable vacation or holiday pay or a deferred amount under a salary deferral arrangement) in respect of an office or employment is unpaid on the day that is 180 days after the end of the taxation year in which the expense was incurred, for the purposes of this Act other than this subsection, the amount shall be deemed not to have been incurred as an expense in the year and shall be deemed to be incurred as an expense in the taxation year in which the amount is paid.*

While payments under RSUs can come under the definition of salary deferral arrangements, they are generally not deductible until the point in time they are paid, and therefore taxable to the employee.

4.2.2 RSUs are taxable in the hands of the employee when received, and valued at the amount actually paid for tax purposes [SEC #10, p. 3]. They are deductible by the employer at the same time. Because of the quarterly accounting adjustments by Enbridge, the accumulated amount deducted for tax purposes over the 35 month vesting period should in most cases, and subject to the RCAM true-up issue, be equal to the amount taxed and deducted at the time of payment.

4.2.3 We note that Enbridge advises that the RSUs are deductible for EGD at the time the expense is accrued. This is not the actual tax treatment of RSUs. Rather, EGD pays the accrued amount of the RSU to its parent company as an intercompany fee, and it is deductible on that basis, like any other fee. EI then is eligible to deduct the amount only when it is paid to the employee.

4.2.4 The tax treatment of RSUs informs the Board in that it demonstrates the taxing authorities' conclusion that RSUs are a cost to the employer, and a benefit to the employee, only when actually paid. This differs from the normal tax rule in section 9 of the Income Tax Act, i.e. that accrual accounting is used to determine the timing of business expenses.

5 PERFORMANCE STOCK UNITS

5.1 *Description of Performance Stock Units (PSUs)*

5.1.1 Performance Stock Units are in all respects identical to Restricted Stock Units, with one exception. The calculation of the PSU is based on the price of EI shares, but then it is adjusted based on two factors:

(a) the EI earnings per share, which must increase by at least 3% per year compounded, and must meet a standard relative to peer group companies, and

(b) achievement of a given price to earnings ratio as compared to a specific group of peer group companies.

5.1.2 Thus, PSUs can be thought of as an RSU, with an added variable based on the profitability of the parent company. Depending on the profitability as measured by the metrics described above, the value of the PSU can be from 0% to 200% of the EI share price at the time of payment.

5.2 *Nature of the Performance Incentive*

5.2.1 We note that the performance incentive, because of how it fits into the formula, completely controls the amount of the bonus. No part of the bonus is based on criteria applicable to the regulated entity, such as expense control, efficiency measures, health and safety, etc., as would be the case in a normal incentive plan for utility employees. Only the profitability of the parent company is relevant, so no employee receiving PSUs is incented to do anything to benefit the utility or its ratepayers.

5.3 *Tax Treatment*

5.3.1 PSUs are taxed in all respects the same as RSUs. Our comments in Section 4 of this final argument, above, apply equally here.

6 PROPOSED REGULATORY TREATMENT

6.1 *Incentive Stock Options*

6.1.1 In our submission, the federal Department of Finance has it right when it comes to the timing and value of stock option compensation. Aside from the tax preference given in limited circumstances, the Income Tax Act says that stock options are recognized as compensation at the time the option is exercised, and the amount of the compensation is the difference between the market price at the time of exercise, and the strike price.

6.1.2 In addition to being conceptually sound, this timing has a number of more practical advantages. First, it adjusts for changes in stock price, expiry of options, and forfeitures. Second, it treats the grant as a cost only when the company experiences the dilution associated with the issuance of shares at a discount [referred to at page 5 of the EB-2006-0034 decision]. Third, it deals with situations like 2009, when stock prices fell and stock options were "under water", despite the accrued expenses for those options continuing to be charged to income.

6.1.3 Valuation is a little more difficult. On the one hand, the valuation used for tax purposes is a simple one, that reflects the final benefit received by the employee, and therefore the "compensation value" of the ISO. On the other hand, the amount considered to be an expense for accounting purposes is a different amount, calculated at the time of grant, and often lower than the value to the employee for tax purposes.

6.1.4 In our submission, it would not be appropriate either to allow an expense for regulatory purposes that exceeds the accounting cost, or to allow an expense in excess of the actual benefit ultimately received by an employee. We therefore propose that the amount of the expense be the lesser of the expense calculated for accounting purposes, and the benefit delivered to the employee.

6.1.5 We are also concerned about the lack of tax deductibility of this compensation, which increases its cost materially. One alternative is to use the same solution as the Income Tax Act, which only taxes the employee on 50% of the value of the benefit, in recognition in part of the lack of employer deductibility. That would be one solution for ratemaking, but we do not believe the best one.

6.1.6 The alternate, and better, solution is to mirror the regulatory treatment of the expense with a similar tax treatment. Just as the Board treats this non-cash compensation the same as cash compensation, even though there is no actual payment, in our submission, the utility should be required to calculate its provision for income taxes as if this compensation were cash compensation and therefore tax deductible. This would result in symmetry, i.e. deeming of the expense, and deeming of a consistent tax treatment.

6.1.7 Finally, if the Board adopts the timing and valuation proposals we are making, an appropriate transition is required. The Applicant has been expensing ISOs prior to exercise in the past. Therefore, when a stock option is exercised today, an amount relative to that stock option has already been expensed for regulatory purposes. That amount that has already been expensed should be deducted from the value of the stock option exercised in a given year, and only the net amount included as a regulatory expense in the year of exercise..

6.1.8 In summary, therefore, we propose that, for ISOs:

(a) The expense be calculated at the time of the exercise of the option.

(b) The amount of the expense be the lesser of the amount calculated for accounting purposes, and the benefit actually conferred on the employee as calculated for tax purposes (without the 50% reduction).

(c) Deducted from the amount of the expense as otherwise calculated should be any amount previously expensed, directly or indirectly, related to that option for regulatory purposes (including through RCAM or other indirect payment cost mechanisms).

(d) The utility's provision for taxes be calculated as if the ISO compensation is deductible in the same manner as cash compensation.

6.1.9 The result of these recommendations for 2009 would necessarily be that there can be no 2009 ISO expense, since all amounts related to exercised stock options would have been expensed in prior years using the old methodology**.**

6.2 ***Restricted Stock Units***

6.2.1 This Board panel is considering the issue of Enbridge's RSUs for the first time. In our submission the RSUs should be treated as deferred bonuses, in which no liability exists until the date of payment.

6.2.2 Therefore, an RSU should in our submission be treated as an expense in the year in which it is paid, and valued at the amount actually paid.

6.2.3 As with ISOs, a transitional rule is required. For each RSU paid in a given year, there may have been amount accrued in respect of that RSU in a prior year. That amount should be deducted from the amount of that RSU actually paid in the year, and the net amount, positive or negative, treated as an expense.

6.2.4 Because there were no RSUs until 2007, none have vested as yet, so none could have been paid in 2009 [SEC #9, p. 5]. Therefore, the RSU expense for 2009 must be zero.

6.3 ***Performance Stock Units***

6.3.1 In our submission, PSUs are structured solely to targets earnings maximization in the parent company. Since this does not benefit the ratepayers, the Board should treat this as a shareholder expense and not as a ratepayer expense. While it is compensation to the employees, it is not compensation for their duties on behalf of the utility. Rather, it is separate compensation for an employee's duty to look after the interests of the parent company.

7 OTHER MATTERS

7.1 *Costs*

7.1.1 The School Energy Coalition hereby requests that the Board order payment of our reasonably incurred costs in connection with our participation in this proceeding. It is submitted that the School Energy Coalition has participated responsibly in all aspects of the process, in a manner designed to assist the Board as efficiently as possible.

All of which is respectfully submitted.

Jay Shepherd
Counsel for the School Energy Coalition

Canadian Salary Deferral Arrangement Legislation

Publication: Tax Executive
Date: Friday, May 1 2009

HEADNOTE

On May 4, 2009, Tax Executives Institute submitted the following recommendations to the Canadian Department of Finance, recommending changes to the Salary Deferral Arrangement legislation in order to afford greater flexibility in the design of long-term incentive compensation packages. TEI's comments were prepared under the aegis of its Canadian Income Tax Committee, whose chair is Rod C. Bergen of The Jim Rattison Group. Contributing substantially to the development of TEI's comments were Marvin E. Lamb and Stephen Galka of Imperial Oil Limited. Jeffery P. Rasmussen, TEI Tax Counsel, serves as legal staff liaison to the committee.

The Salary Deferral Arrangement (SDA) legislation was enacted more than 20 years ago in order to prevent abuses of the employee benefit plan (EBP) rules by non-taxable employers. While the purpose of the SDA rules is targeted, in application the rules have been applied broadly and impede the development of effective, modern long-term incentive compensation (LTIC) packages that taxable Canadian corporations must offer to attract and retain talented employees. On behalf of Tax Executives Institute, I write to propose changes to the SDA rules that will narrow their scope without undermining their efficacy in preventing excessive accumulations of retirement income by employees of nontaxable employers.

Background

Tax Executives Institute is the preeminent association of business tax executives. The Institute's 7,000 professionals manage the tax affairs of 3,200 of the leading companies in Canada, the United States, Asia, and Europe and must contend daily with the planning and compliance aspects of Canada's business tax laws. Canadians make up 10 percent of TEI's membership, with our Canadian members belonging to chapters in Calgary, Montreal, Toronto, and Vancouver, which together make up one of our nine geographic regions. Our non-Canadian members (including those in Europe and Asia) work for companies with substantial activities in Canada. In sum, TEI's membership includes representatives from most major industries including manufacturing, distributing, wholesaling, and retailing real estate; transportation; financial services; telecommunications; and natural resources (including timber and integrated oil companies). TEI is concerned with issues of tax policy and administration and is dedicated to working with government agencies to reduce the costs and burdens of tax compliance and administration to our common benefit.

Evolution of Compensation Practices Enhances Long-Term Employee Retention

Corporate compensation programs have changed substantially since the SDA rules were adopted in 1986. Then, most compensation programs consisted of a salary, an incentive-based cash bonus, and, as a longterm incentive, ordinary stock options. Over time, employers have complemented these programs by instituting innovative LTIC programs to attract and retain talented employees on a long-term basis.

The longer the rewards under an LTIC program are deferred, the greater the incentive for employees to remain with the employer and the better the employer can align shareholder and employee interests. Moreover, because of (1) concerns in the capital markets about the leveraging and dilutive effects of employee stock options on existing shareholders and (2) recent changes in the accounting for stock options, employers have reduced the use of ordinary stock option grants in favor of LTIC programs, especially those utilizing full-value equity instruments.1 Thus, LTIC programs are increasingly based on restricted stock, restricted stock options, restricted stock units, phantom stock, and tandem programs with multiple incentives. To be effective as an incentive for long-term performance, these plans must be structured for periods longer than three years but the interpretation of the SDA rules inhibits this.

SDA Rules

Under subsection 248(1) of the Income Tax Act, Canada, an SDA is any arrangement, whether funded or unfunded, under which a person has the right in a taxation year to receive an amount after the year where it is reasonable to consider that one of the main purposes for the creation or existence of the right is to postpone tax payable under the Tax Act by the taxpayer in respect of salary or wages for services rendered by the taxpayer in the year or a preceding year. (Emphasis added.) An exception under paragraph (k) of the definition of Salary Deferral Arrangement in subsection 248(1) permits an employee to defer income for up to three years after the year in which the services are performed.

The current SDA rules are essentially unchanged since their adoption more than two decades ago. The government first identified a concern with respect to how certain deferred compensation arrangements were structured under the EBP rules in 1984, describing the issue as follows:

These plans have created an unintended tax deferral opportunity for employees of non-taxable or non-profit employers who are unconcerned by the question of deductibility. A non-taxable employer, such as one in the public sector, can establish and maintain an EBP providing employees with essentially the same tax deferral benefits as a [registered pension plan, registered retirement savings plan, or deferred profit sharing plan] but not subject to any deduction limits.2

In effect, non-taxable employers were using EBPs to provide a tax-free accumulation of retirement income in excess of established retirement deduction limits. To curb that practice, the government explained the proposed SDA rules' purpose, as follows:

As noted in the May 1985 budget, the government is concerned that employee benefit plans can offer unintended tax deferral advantages to certain groups of employees ....

Where the employer is non-taxable, there is no cost to it of entering into an arrangement to permit the employee to defer tax on employment income . . . .

The government is concerned about the implications of such plans for government revenues and the unfair distribution of tax benefits to individuals in different employment situations. The budget proposes a measure designed to prevent this deferral of salary for tax purposes without interfering with other arrangements where employee benefit plans are not primarily motivated by tax deferral considerations.[3]

Despite the government's express concern about the perceived abuse of EBPs by non-taxable employers, the legislation is not limited to such employers. Indeed, the statute is broadly worded. It permits all forms of salary deferral arrangements, whether tax-motivated or not, as long as the deferral period is limited to three years. For plans with deferral periods longer than three years, the provision incorporates a purpose test applicable to all entities - taxable or not - as well as all forms of deferred compensation - funded or unfunded. The SDA rules are not, however, intended to apply to "arrangements where employee benefit plans are not primarily motivated by tax deferral considerations."[4]

Within months of adopting the SDA rules, the government proposed the Retirement Compensation Arrangement (RCA) rules as "new anti-avoidance rules aimed at arrangements entered into to postpone unduly the tax on salary or wages . . . ."[5] The press release introducing the proposed RCA rules describes the notion of "off side" or "non-statutory" retirement plans, implying that such plans differ from the deferred compensation arrangements the SDA rules were implemented to address.[6] The language in the press release announcing the draft RCA legislation, however, is strikingly similar to the language in the 1984 publication Building Better Pensions for Canadians, which provided the background and rationale for adoption of the SDA rules in the 1986 budget. Indeed, one commentator attributes the RCA rules directly to the perceived abuse identified in the government's 1984 policy paper:

The Part XI.3 refundable tax was introduced for the purpose of countering the perceived abuse of the employee benefit plan rules by tax-exempt or other non-taxable employers who provided for deferred tax on retirement benefits without being concerned with the deductibility thereof, deferred or otherwise. . . . The system is therefore designed to prevent the tax-free accumulation of retirement income for the benefit of the employee by levying an advance refundable tax of 50 per cent of contributions and earnings.[7]

Thus, with respect to funded plans, the RCA rules implemented in 1987 effectively address the same deferred compensation arrangements articulated in 1984 that led to the SDA rules. In addition, the government subsequently introduced the specified retirement arrangement (SRA) rules in 1992 to ensure that the amount of RRSP "room" of employees of tax-exempt entities is reduced where the employees are entitled to pension benefits under an unfunded or partially funded and unregistered plan.[8] On a combined basis, the SDA rules substantially overlap the RCA and SRA rules.

In light of that overlap, as well as the evolution of corporate compensation practices since 1986, we believe the purpose and effects of the SDA rules should be re-examined for non-exempt entities.

Discussion

U.S.-based employers are increasingly using full-value share vehicles such as restricted stock and restricted stock units (payable in cash or stock at the employee's election) in their LTIC plans.[9] To satisfy the employers' long-term compensation objectives, three to five years of service is generally required for vesting, with some plans having deferral periods up to ten years.[10] Because of the uncertainty under the SDA rules, such LTIC plans must be adapted for use in Canada.

One major obstacle for taxable Canadian corporations is that Canada Revenue Agency (CRA) interprets the "purpose" test of the SDA rules very broadly. CRA nearly always finds that a full-value plan has a tax deferral purpose whenever the deferral period is longer than three years even where the plan is not structured or motivated by tax deferral considerations." In effect, CRA's rulings focus on the characteristics or outcome of the plan rather than on the purpose of the plan. Indeed, in response to a request to issue guidelines describing when a "purpose" would be found the Agency stated, "Because of the wide variety of arrangements ... we have not been able to formalize general guidelines as to what will, or will not, be evidence of 'purpose' or as to the difference between 'purpose' and 'main purpose.'"[12] More than 20 years have elapsed since CRA's initial statement and no additional guidance has been promulgated with respect to the purpose test. As important, no consensus has emerged among practitioners about how to design a plan that complies with it. Consequently, Canadian LTIC plan designers stay within the three-year safe-harbour rule of paragraph (k) in the definition of an SDA in subsection 248(1).

The three-year rule, however, frustrates employers' objectives of establishing a long-term incentive plan. In today's global economy, the use of full-value share vehicles with vesting provisions longer than three years is necessary to (1) attract and retain the most talented individuals and (2) align the long-term interests of those key employees with shareholders. As a result, Canadian employers are at a competitive disadvantage with those in the United States that are afforded more scope in their plan designs.

To ensure that the Canadian tax treatment of LTIC plans is competitive with the United States while preserving administrable and consistent tax policy rules for the treatment of such plans, we suggest that the Department of Finance consider introducing changes to the SDA legislation or the Income Tax Regulations. Specifically, consistent with the legislative background of the SDA provision (discussed above and cited in footnotes two through four), we suggest the following alternatives:

* limit the rules to tax-exempt employers. (Employers that pay income tax under statutes such as the Ontario Electricity Act, 1998, and similar provincial legislation should not be considered tax exempt).

* prescribe conditions under which an SDA will be deemed not to violate the purpose test. For example, the purpose test might be limited to situations where tax symmetry is not maintained between a non-exempt employer's deduction and the employee's income inclusion. So long as a plan is unfunded and no cash or benefit is transferred to the employee, there would seem to be no tax policy reason for accelerating both the employer's deduction and the employee's income inclusion simply because the incentive period exceeds an arbitrary three-year limit.13

TEl urges the Department of Finance to revisit the SDA rules to clearly delineate the tax policy differences between acceptable and unacceptable deferred compensation programs, especially where the "purpose" test might apply. We submit that a threeyear period is too abbreviated to permit employers to build effective, long-term incentive plans that encourage employee retention and long-term performance. If an indefinite deferral period is not possible, we recommend that the Department consider providing a 10-year limit on LTIC plans. We would appreciate an opportunity to meet with representatives of the Department of Finance in order to discuss our recommendations and proposals.

Conclusion

TEI's comments were prepared under the aegis of the Institute's Canadian Income Tax Committee, whose Chair is Rod Bergen. If you should have any questions about the recommendations, please do not hesitate to call Mr. Bergen at 604.488.5231 begin_of_the_skype_highlighting 604.488.5231 end_of_the_skype_highlighting (or Bergen@jp-group. com) or Sherrie Ann Pollock, TEI's Vice President for Canadian Affairs, at 416.955.7373 begin_of_the_skype_highlighting 416.955.7373 end_of_the_skype_highlighting (or sher r ieann . pollock@rbcdexia .com) .

REFERENCE

1. A "full-value" equity instrument is any form of compensation that, once vested, will be based upon the full value of the underlying company shares. In a stock option or stock appreciation rights (SAR) plan, the recipient benefits from the appreciation in value of the underlying stock subsequent to the grant. In other words, for an SAR or a stock option plan to have value, the price of the underlying stock must rise and stay above the exercise price. By contrast, in a "full-value" incentive plan, unless the stock's value plummets to zero, the equity instrument will always have some value to the recipient upon the lapse of a vesting period or other plan restriction.

2. See Building Better Pensions for Canadians Improved Tax Assistance for Retirement Saving, Department of Finance (February 1984), at 12 (Emphasis added).

3. See Securing Economic Renewal - Federal Budget Papers, Department of Finance (February 26, 1986), at 35-36. See also Securing Economic Renewal- Federal Budget Papers (May 23, 1985), at 56.

4. Securing Economic Renewal- Federal Budget Papers, Department of Finance (February 26, 1986), at 36 (Emphasis added).

5. See A Better Pension System- Saving for Retirement, Improved Tax Treatment: Detailed Rules and Procedures, Department of Finance (October 1986). "The February 26, 1986 budget proposed new anti-avoidance rules aimed at arrangements entered into to postpone unduly the tax on salary or wages . . . . The existing rules relating to employee benefit plans permit the deferral of tax on certain pension and retirement arrangements that are not registered. These plans are generally referred to as "off-side" pension plans and can be used to circumvent the limits on tax assistance provided with respect to RPPs and other statutory plans such as RRSPs and DPSPs. Off-side pension plans are utilized ... by employees of nontaxable entities. New rules are proposed for retirement compensation arrangements that are designed to remove the tax benefits flowing from the use of off-side plans."

6. See Department of Finance Press Release (March 27, 1987).

7. Canada Tax Service - McCarthy Tétrault Analysis, 207.5-207.7 - Tax in respect of Retirement Compensation Arrangements.

8. For the SRA rules, see section 8308.3 of the Income Tax Regulations.

9. The trend toward the use of full-value share plans instead of options was accelerated by the revision of the financial accounting treatment of options under FAS 123(R). See Current Trends in Executive Compensation, Culpepper Compensation & Benefits Surveys (September 12, 2006). See also Equity Compensation Continues Shift Towards Restricted and Performance-Based Stock, Culpepper Compensation & Benefits Surveys (March 9, 2006).

10. In the United States, deferred compensation is generally governed by Internal Revenue Code section 409A. Under those rules, U.S. employers are not restricted in the amount, form, instrument, calculation method, or duration of the deferred compensation. Instead, the rules prescribe the time for making deferral elections and generally restrict the employees' ability to make subsequent changes.

11. Several interpretations acknowledge that deferred compensation payable more than three years from the date the services are performed may be in the form of a restricted stock unit, but the amount to be paid must be limited to the appreciation in the value of the underlying equity unit subsequent to the date of grant. See, e.g., Technical Interpreta- tion 2003-0001905-Restricted stock units sal- ary deferral arrangement rules (April 15, 2003). Other interpretations require the amount paid beyond the three-year period to be totally de- pendent on future earnings events. See, e.g.. Technical Interpretation 2000-0056537- Salary deferral arrangement incentive based on future earnings (November 24, 2000).

12. See Revenue Canada Roundtable, Q.27 Main Purpose of Postponing Tax Payable, Report of THE PROCEEDINGS OF THE FORTIETH TAX CONFERENCE (1988 Canadian Tax Foundation Meeting), at 53:44-45.

13. As a result of the accelerated income inclusion the employee will bear a significant cash tax burden before any cash is available to pay the tax. The employer receives an immediate tax deduction pursuant to paragraphs 20(1)(oo) or 20(1)(pp) of the Act even though no cash outlay or payment may be made for several years, which is a notable exception to the 180-day rule in subsection 78(4) of the Act for deducting accrued but unpaid compensation.