CANADIAN VENTURE CAPITAL & PRIVATE EQUITY ASSOCIATION

September 16, 2019

Tax Policy Branch
Department of Finance Canada
90 Elgin Street
Ottawa, Ontario
K1A 0G5

RE: Consultations on Proposed Changes to the Tax Treatment of Employee Stock Options

About the Canadian Venture Capital and Private Equity Association
The Canadian Venture Capital and Private Equity Association (CVCA) is the voice of the venture capital and private equity industry in Canada. Our members invest in Canadian companies at every stage of a business's development: from start-up, through scale-up and international expansion, to exit. It is proven that venture capital and private equity enhances productivity, creates high paying jobs and increases competition, all of which are key to contributing to a higher standard of living for Canadians. The CVCA and our membership strongly believe that a favourable and competitive ecosystem for private capital are essential ingredients to Canada's future economic growth.

The CVCA proudly links venture capital and private equity firms, debt and equity providers, international investors, institutional funds, government entities, angel investors and family offices. We bring all the pieces together to keep our industry engaged, fluid and strong.

The CVCA connects over 1,500 individual members and over 260 member organizations and we are Canada's ultimate resource for data on Canadian private capital investments.

Context

We are pleased to participate in the government's consultation on *Proposed Changes to the Tax Treatment of Employee Stock Options* and appreciate the opportunity to provide our industry's views regarding the characteristics of companies that should be considered start-ups, emerging or scale-up companies. The Canadian venture capital and private equity market is an essential component of Canadian innovation and growth. Private capital investors, particularly venture capital (VC) investors, help to build and grow Canadian start-up companies. Private capital managers bring more than just money—they bring talent, connectivity, know-how and experience that Canadian entrepreneurs can rely on. These attributes lead to success.

Canadian VC-backed companies have stronger sales growth, revenue growth, employee growth, asset growth, wage growth and R&D expenditure growth than their non-VC-backed counterparts.

Similar evidence is available on the private equity side. Buyout transactions also have significantly outsized positive and lasting impacts on innovation through patents, productivity, governance, wage increases and management practices.

The Challenge: Global Competition for Talent

It is well documented and understood that the competition for talent is both fierce and global. Recognizing this, Canada has begun addressing the talent shortage in its innovation ecosystem. The government's adoption of the Global Talent Stream for skilled workers is a clear example of this. The CVCA strongly supports the government's efforts to attract and retain world class talent. It is in this context that we provide our input on this important topic, as stock options are a critical tool in attracting and retaining the talent needed to start, grow and scale Canadian businesses.

Canadian start-up companies, as well as companies in need of strategic direction later in their business journey, require highly skilled and C-suite talent. For start-ups, these individuals provide founders with guidance on how to navigate the challenges experienced during a company's growth phase and the preparation needed to exit through an initial public offering (IPO). These senior executives are difficult to attract as the demand for their skillset and experience is high. Canadian companies are thus competing internationally for their attention.

Stock options represent a strategic incentive to attract and retain the talent required to build and grow competitive Canadian companies. When a new company cannot provide a certain level of compensation because steady revenue and profit have not yet materialized, providing stock options allows our companies to attract the critical talent they need with the promise of future remuneration.

Supporting Business Growth in Canada: Examples of Success

Looking at publicly available definitions of companies, we have found that start-up, scale-up and growth companies can be defined as follows:

A **start-up** is a company that is in the first stage of its operations. These companies are often initially bankrolled by their entrepreneurial founders as they attempt to capitalize on developing a product or service for which they believe there is a demand.

A scale-up is a **company** who has an average annualized return of at least 20% in the past 3 years with at least 10 employees in the beginning of the period (OECD, 2007).

A growth company is **any company whose business generates significant positive cash flows or earnings**, which increase at significantly faster rates than the overall economy.

The deal size and later stage funding of Canadian companies across these three classifications have been growing year-over-year (see tables below).

Average Canadian VC Deal Sizes

	2013	2014	2015	2016	2017	2018	H1 2019
Total	$5.19	$4.71	$4.33	$6.06	$8.00	$7.19	$8.39

Source: CVCA Intelligence

Average Canadian Later Stage VC Deal Sizes (in CAD millions)

2013	2014	2015	2016	2017	2018	H1 2019
$11.05	$9.50	$7.35	$15.92	$24.10	$15.86	$19.59

Source: CVCA Intelligence

In turn, the context of the start-up, emerging and scale-up market is fluid, and thus it is not easy to quantify today what these different categories may be in the future.

However, special attention is often given to *unicorns*, which are commonly defined as start-up companies that have reached the valuation threshold of $1B+. It is important that Canada continue to maintain and enhance its business environment to produce such unicorns as they are key drivers of jobs, innovation and economic growth. Moreover, unicorns are clear demonstration points of Canadian innovation and the effectiveness of the Canadian business environment and ecosystem. As such, we have chosen to look more closely at this class of business to inform our recommendation.

The examples below demonstrate the varied growth journey of such companies and offer important insights regarding the characteristics of companies that should be considered when defining start-ups, emerging or scale-up companies.

<u>Shopify</u>

Ottawa-based Shopify is one of the best-known e-commerce platforms in the world. The company originally started as a snowboard retailer before getting frustrated with the lack of e-commerce options, resulting in a pivot in business direction in 2006 and launching as the Shopify we know it as today. It took only a few years for it to turn a profit, and now the company boasts roughly $29 billion in sales and over 377,000 active shops on its platform. Shopify, which held its IPO in 2015, now has nearly 2,000 employees and five office locations. As of 2019, Shopify has reached a level of maturity that would exclude it from qualifying as a start-up, emerging or scale-up company, while the following two examples have not. However, at time of their IPO, we estimate that Shopify's taxable capital was CAD $128M and the company still very much required the ability to use stock option incentives to secure the talent required to continue its strong growth trajectory.

Real Matters

Founded in 2004, Markham, Ontario-based Real Matters is a network management services platform for the mortgage and insurance industries. The company made headlines in May 2017 when it became the company to end the two-year dry spell for Canadian tech IPOs. Real Matters has offices in Markham, Buffalo, Denver and Middletown and has around 65 employees. At the time of their IPO, we estimate that Real Matter's taxable capital was CAD $298M. Despite this level of taxable capital, Real Matters currently operates at a loss as it continues to invest to scale its business. In turn, for Real Matters, applying a $200,000 limit on the amount of yearly employee stock options that may vest and continue to qualify for the stock option deduction would severely restrict the company's ability to compete for talent in the global market. The combination of lack of profit and a hard limit on the stock option deduction would place Real Matters at a disadvantage compared to its international competition to attract highly skilled talent.

Lightspeed POS

Montreal-based Lightspeed POS was founded in 2005 with the mission of helping businesses re-create an e-commerce shopping experience that provided ease, personalization, and product information. From 2006 to 2011, Lightspeed had 1900% growth and was recognized as one of Canada's fastest growing companies. In March 2019, Lightspeed debuted on the Toronto Stock Exchange and now has over 700 employees in Montreal, Ottawa, Ghent, Amsterdam, Olympia, London, and New York. At the time of Lightspeed's IPO, we estimate their taxable capital was CAD $337M. However, like Real Matters, Lightspeed POS also continues to operate at a loss as it works to rapidly build out its business. Thus, also like Real Matters, the combination of lack of profit and a hard limit on the stock option deduction would place Lightspeed POS at a disadvantage compared to its international competition to attract the talent it requires to grow.

These three examples provide a window on how valuations, business generation and taxable capital can vary from one company to another. The figures attached to taxable capital were at the moment of their IPO while their growth journey was just beginning. Despite being *unicorns* with $1B+ valuations and significant taxable capital at the time of IPO, each still had the material need to use stock options as a key tool to attract and retain the global talent that would sustain and accelerate their impressive growth.

The CVCA believes that Canada needs to be vigilant in maintaining and enhancing its business environment to produce more of these types of successes in a more consistent manner. The use of stock options is a key component of attracting the talent required to grow these critical companies.

Recommendations

The CVCA examined the financials of these three unicorns at the time of their IPOs to inform our recommendation. In consultation with our members, including those who were involved in the early financing of these great Canadian companies, the CVCA recommends that a non-CCPC start-up, emerging or scale-up company should be defined as:

- Any Canadian-resident corporation (other than a Canadian-controlled private corporation) with taxable capital of less than CAD $500M.

After careful consideration about the metric that should be used to determine the threshold from a start-up, emerging and scale-up company to that of a mature company, the CVCA identified taxable capital as most relevant for three reasons: 1) it is a threshold that can be clearly defined; 2) the data demonstrates the true size of the organization; and, finally 3) all publicly traded companies must disclose this information.

The CVCA believes there should not be any additional administrative and compliance implications associated with this recommendation and should be absorbed into CRA's existing process as it is tied to company annual tax filings.

It should be noted that personal tax rates are generally materially higher in Canada than in the United States, and the stock option deduction is necessary for Canadian companies to remain competitive when recruiting executive talent. This competitive advantage will be lost with the proposed taxation of employee stock options.

The CVCA and its membership appreciate the opportunity to participate in this consultation process and provide our perspective on this important issue. We would be happy to meet with departmental officials to review our submission and the perspective of the industry in greater detail.