

The Navigator



Wealth
Management

RBC Wealth Management Services



Aaron Fennell, MBA, CFA
Investment Advisor
aaron.fennell@rbc.com
416-313-6397

RBC Dominion Securities Inc.
181 Bay Street, Suite 2350
Toronto, ON M5J 2T3
www.aaronwfennell.com
866-605-3295

Taxation of options transactions

Options can provide you with flexible investment choices

Depending on the contract, options can protect or enhance your portfolio in rising, falling and neutral markets. As flexible as options are, they are quite complex to understand and are not appropriate for all investors. The purpose of this article is to provide a general overview of option transactions as well as how to report them for tax purposes.

The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax advisor before acting on any of the information in this article.

What is an option?

Options are contracts which allow buyers (holders) and sellers (writers) to buy or sell an underlying share at a specific price (referred to as the strike price), on or before a certain date (referred to as the expiration date). The cost of an option is called the premium. The premium is determined by factors including the stock price, strike price, time remaining until expiration and volatility.

Buyers and sellers

The important distinction between buyers and sellers is that buyers have the right (but not the obligation) to buy or sell the underlying shares. Buyers can always let the expiration date pass without exercising their right. Sellers, on the other hand,

have the obligation to buy or sell the underlying shares at the strike price on or before the expiration date. This obligation arises if assigned by the buyer.

Calls and puts

There are two types of options: Calls and puts.

Calls

Calls give the holder the right to **buy** shares at the strike price on or before the expiration date. Buyers of calls hope that the shares will increase substantially before the option expires. If you are a buyer, it makes sense to exercise a call option if the share price is above the strike price. This option position is referred to as being “in the money”.

In order to determine the tax consequences of an option transaction, you need to establish whether the transaction is considered on account of income or capital.

In order for a buyer to buy a call, a seller needs to write a call option. Sellers of calls generally expect that the price of the underlying shares will fall and they will not need to deliver the underlying shares to the buyer.

Puts

Puts give the holder the right to sell shares at the strike price on or before the expiration date. Buyers of puts hope that the price of the shares will fall before the option expires. A put option is in the money when the share price is below the strike price.

In order for a buyer to buy a put, a seller needs to write a put option. Sellers of puts generally expect that the price of the underlying shares will increase and they will not have to buy the underlying shares from the buyer.

Types of option transactions

There are four types of options transactions you can enter into:

	Buyer of the option	Seller of the option
Calls	Holder has the right to buy	Writer has the obligation to sell
Puts	Holder has the right to sell	Writer has the obligation to buy

Options with life spans longer than one year are often referred to as Long-Term Equity Anticipation Securities (LEAPS), but these are still call or put options in substance.

Covered and naked options

If an option is covered, this means that the seller owns the corresponding amount of the underlying shares. Conversely, if an option is naked, this means that the seller does not own any, or enough, of the underlying shares. Trading naked options is only suitable for experienced traders since it is a risky endeavour and the potential for

losses is unlimited. For example, say the seller writes a call option and expects the price of a particular share to fall. Instead of falling, the price of the share increases substantially. The seller, who does not already own the underlying share, will be required to purchase the share regardless of how high the price is, and then sell it to the option buyer at the strike price.

Exiting an option

As a buyer, when you buy a put or a call option, there are three potential outcomes:

1. The option is in the money and you may choose to exercise the option.
2. The option is out of the money and worthless, so you let the option expire unexercised.
3. You close out the option with an offsetting trade, prior to expiration.

As a seller, when you sell a put or a call option, there are three potential outcomes:

1. The buyer exercises the option and you get assigned.
2. The option expires unexercised.
3. You close out the option with an offsetting trade, prior to expiration.

What are the tax consequences of option transactions?

In order to determine the tax consequences of an option transaction, you need to establish whether the transaction is considered on account of income (business income or loss) or capital (capital gain or loss). This determination depends on your specific circumstances and the nature of the transaction. If it is determined that the option transaction is on account of income, the full amount of any gain must be included in your income and taxed at your marginal tax rate. The full amount of any loss is deductible against income from any source (such

Although there is no definitive rule to determine if a particular transaction is on account of income or capital, the Canada Revenue Agency (CRA) has provided some guidance in their Interpretation Bulletin IT-479R.

as business income, employment income, or capital gains). If the loss cannot be deducted within the year, it may be carried back three years or carried forward 20 years.

If it is determined that the option transaction is on account of capital, half of the capital gain is taxable and must be included in income. Similarly, half of any capital loss is deductible, but the loss can only be used to offset taxable capital gains. If the loss cannot be deducted within the year, it may be carried back three years or carried forward indefinitely.

Are gains and losses on account of income or capital?

Although there is no definitive rule to determine if a particular transaction is on account of income or capital, the Canada Revenue Agency (CRA) has provided some guidance in their Interpretation Bulletin IT-479R.

The CRA has stated that the proceeds of sale will normally be considered to be on income account (income from business) where the person is a “trader or dealer in securities”. A trader or dealer in securities is generally a person who makes it a profession or a business of buying and selling securities. Some factors that are considered when determining whether a person is a trader or dealer in securities are: the frequency of the transactions, the period of the holdings, the knowledge of the securities market, the time spent studying the securities market and investigating potential purchase, and the intention to acquire for resale at a profit.


Subject to certain exceptions, if you are not considered a trader or dealer in securities, you may make an irrevocable election in your income tax return that deems all Canadian securities you own in that year and in any subsequent year be treated as capital property. This means that the proceeds from every security you

sell in that year and all subsequent years will be treated as a capital gain or loss. The election is made by filing form T123 – Election on disposition of Canadian securities. For any such election made after December 19, 2006, Quebec residents are also required to notify Revenu Quebec in writing about the election and include a copy of any document that was filed with CRA in respect to that election.

The CRA generally presumes that the gain or loss realized by a buyer of options or a seller of covered options is on the same account as the underlying shares. This means that if the gain or loss on the sale of the underlying shares would be treated as a capital gain or loss, then the gain or loss on the call or put option transaction would also be treated as a capital gain or loss.

This presumption may not apply where the facts clearly indicate otherwise. The CRA gives an example where a holder of options usually trades shares on income account, but also holds a separate group of shares for investment purposes which are properly reported on capital account. In this situation the CRA comments how the option transactions with respect to the former group should be reported on income account and the latter group on capital account. Lastly, the CRA states that the gain or loss realized by a seller of naked options is normally on account of income. However, the CRA will allow these gains and losses to be reported on account of capital provided this method is followed consistently from year to year.

As the determination of the tax treatment can be subject to interpretation, it is always recommended that you seek professional tax advice whenever you realize gains or losses on option transactions. Using a consistent approach year over year will help reduce the risk of a challenge by the CRA.



Using a consistent approach year over year will help reduce the risk of a challenge by the CRA.

Tax treatment for transactions on account of capital

For most people, gains and losses arising from options transactions are

treated on account of capital. The following tables describe the tax treatment for option transactions that are on account of capital.

For the buyer of a call option (the right to buy shares)

Transaction	Tax Implications for capital gain or loss
It remains outstanding	Year 1: ACB of option = option premium paid + commissions paid CG or CL only realized in the year of expiry or sale
It is exercised in Year 1	Year 1: ACB of shares = (option premium paid + commissions paid) + (exercise price paid + commissions paid) CG or CL only realized in the year the shares are sold
It expired in Year 1	Year 1: CL = option premium paid + commissions paid
It is sold in Year 1	Year 1: CG/CL = (option proceeds received – commissions paid) – (option premium paid + commissions paid)
It is exercised in Year 2	Year 1: N/A Year 2: ACB shares = (option premium paid + commissions paid) + (exercise price + commissions paid) CG or CL only realized in the year the shares are sold
It expired in Year 2	Year 1: N/A Year 2: CL = option premium paid + commissions paid
It is sold in Year 2	Year 1: N/A Year 2: CG/CL = (option proceeds received – commissions paid) – (option premium paid + commissions paid)

For the seller of a call option (the obligation to sell shares)

Transaction	Tax Implications for capital gain or loss
It remains outstanding	Year 1: CG = option premium received – commissions paid
It is assigned in Year 1	Year 1: CG/CL = (option premium received – commissions paid) + (share proceeds received – commissions paid) – ACB of underlying shares
It expired in Year 1	Year 1: CG = option premium received – commissions paid
It is closed out in Year 1	Year 1: CG/CL = (option proceeds received – commissions paid) – (option premium paid + commissions paid)
It is assigned in Year 2	Year 1: CG/CL = option premium received – commissions paid Year 2: Amend Year 1 tax return to reduce the previously included CG to nil. Report new CG/CL = (option premium received – commissions paid) + (share proceeds received – commissions paid) – ACB of underlying shares
It expired in Year 2	Year 1: CG = option premium received – commissions paid Year 2: N/A
It is closed out in Year 2	Year 1: CG = option premium received – commissions paid Year 2: CL = option premium paid + commissions paid

It is always recommended that you seek professional tax advice whenever you realize gains or losses on option transactions

For the buyer of a put option (the right to sell shares)

Transaction	Tax Implications for capital gain or loss
It remains outstanding	Year 1: ACB of option = option premium paid + commissions paid CG or CL only realized in the year of expiry or sale
It is exercised in Year 1	Year 1: CG/CL = (share proceeds received – commissions paid) – (option premium paid + commissions paid) – ACB of underlying shares
It expired in Year 1	Year 1: CL = option premium paid + commissions paid
It is sold in Year 1	Year 1: CG/CL = (option proceeds received – commissions paid) – (option premium paid + commissions paid)
It is exercised in Year 2	Year 1: N/A Year 2: CG/CL = (share proceeds received – commissions paid) – (option premium paid + commissions paid) – ACB of underlying shares
It expired in Year 2	Year 1: N/A Year 2: CL = option premium paid + commissions paid
It is sold in Year 2	Year 1: N/A Year 2: CG/CL = (option proceeds received – commissions paid) – (option premium paid + commissions paid)

For the seller of a put option (the obligation to sell shares)

Transaction	Tax Implications for capital gain or loss
It remains outstanding	Year 1: CG = option premium received – commissions paid
It is assigned in Year 1	Year 1: ACB of shares = (exercise price paid + commissions paid) – (option premium received – commissions paid) CG or CL only realized in the year the shares are sold
It expired in Year 1	Year 1: CG = option premium received – commissions paid
It is closed out in Year 1	Year 1: CG/CL = (option premium received – commissions paid) – (option premium paid + commissions paid)
It is assigned in Year 2	Year 1: CG = option premium received – commissions paid Year 2: Amend Year 1 tax return to reduce the previously included CG to nil. ACB of shares = (exercise price paid + commissions paid) – (option premium received – commissions paid) CG or CL only realized in the year the shares are sold
It expired in Year 2	Year 1: CG = option premium received – commissions paid Year 2: N/A
It is closed out in Year 2	Year 1: CG = option premium received – commissions paid Year 2: CL = option premium paid + commissions paid



Please contact us for more information about the topics discussed in this article.

Conclusion

The tax treatment of option transactions is very complex. You first need to determine if the option transactions should be reported on account of income or capital. You then need to determine when the gains or losses are realized for tax purposes. To ensure your own circumstances are properly considered, we strongly recommend that you seek advice from a qualified tax advisor before buying or selling options.



**Wealth
Management**

This document has been prepared for use by the RBC Wealth Management member companies, RBC Dominion Securities Inc. (RBC DS)*, RBC Phillips, Hager & North Investment Counsel Inc. (RBC PH&N IC), RBC Global Asset Management Inc. (RBC GAM), Royal Trust Corporation of Canada and The Royal Trust Company (collectively, the "Companies") and their affiliates, RBC Direct Investing Inc. (RBC DI) *, RBC Wealth Management Financial Services Inc. (RBC WMFS) and Royal Mutual Funds Inc. (RMFI). *Member-Canadian Investor Protection Fund. Each of the Companies, their affiliates and the Royal Bank of Canada are separate corporate entities which are affiliated. "RBC advisor" refers to Private Bankers who are employees of Royal Bank of Canada and mutual fund representatives of RMFI, Investment Counsellors who are employees of RBC PH&N IC, Senior Trust Advisors and Trust Officers who are employees of The Royal Trust Company or Royal Trust Corporation of Canada, or Investment Advisors who are employees of RBC DS. In Quebec, financial planning services are provided by RMFI or RBC WMFS and each is licensed as a financial services firm in that province. In the rest of Canada, financial planning services are available through RMFI, Royal Trust Corporation of Canada, The Royal Trust Company, or RBC DS. Estate & Trust Services are provided by Royal Trust Corporation of Canada and The Royal Trust Company. If specific products or services are not offered by one of the Companies or RMFI, clients may request a referral to another RBC partner. Insurance products are offered through RBC Wealth Management Financial Services Inc., a subsidiary of RBC Dominion Securities Inc. When providing life insurance products in all provinces except Quebec, Investment Advisors are acting as Insurance Representatives of RBC Wealth Management Financial Services Inc. In Quebec, Investment Advisors are acting as Financial Security Advisors of RBC Wealth Management Financial Services Inc. RBC Wealth Management Financial Services Inc. is licensed as a financial services firm in the province of Quebec. The strategies, advice and technical content in this publication are provided for the general guidance and benefit of our clients, based on information believed to be accurate and complete, but we cannot guarantee its accuracy or completeness. This publication is not intended as nor does it constitute tax or legal advice. Readers should consult a qualified legal, tax or other professional advisor when planning to implement a strategy. This will ensure that their individual circumstances have been considered properly and that action is taken on the latest available information. Interest rates, market conditions, tax rules, and other investment factors are subject to change. This information is not investment advice and should only be used in conjunction with a discussion with your RBC advisor. None of the Companies, RMFI, RBC WMFS, RBC DI, Royal Bank of Canada or any of its affiliates or any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. © Registered trademarks of Royal Bank of Canada. Used under license.