Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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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 if they are held as capital property.

What is an option?

Options are contracts that 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, which is paid by the buyer to the seller of the option. The premium is determined by factors including the price of the underlying share, strike price, time remaining until expiration and price volatility of the share.

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 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 the seller owns the corresponding amount of the underlying shares. Conversely, if an option is naked, the seller does not own any, or enough, of the underlying shares. Trading naked options is only suitable for experienced traders since it's 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.

If an option is covered, this means the seller owns the corresponding amount of the underlying shares. Conversely, if an option is naked, the seller does not own any, or enough, of the underlying shares.

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's 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 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's 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's 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 the CRA may consider when determining whether you are a trader or dealer in securities are: the frequency of the transactions, the holding period of the securities, your knowledge of the securities market, the time spent studying the securities market and investigating potential purchase, and whether you intended to acquire the securities 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 the proceeds from every Canadian 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 Québec in writing about the election and include a copy of any document that was filed with the 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 if the gain or loss on the sale of the underlying shares would be treated as a capital gain or loss, the gain or

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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’s always recommended that you seek advice from a qualified tax advisor whenever you realize gains or losses on option transactions. Using a consistent approach year over year may 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 (CG or CL)**
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

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 buy 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

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, it's strongly recommended that you seek advice from a qualified tax advisor before buying or selling options.

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Wealth Management

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