

# The Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES



Wealth  
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## Donation of employee stock option shares

A strategy to eliminate tax on the exercise of your options and meet your philanthropic goals

As an employee, you may have been granted stock options by your employer. Generally, there are no tax implications when the stock options are first granted to you. However, when you decide to exercise the options, you will realize a security options benefit. Once you have exercised the options, consider donating the shares acquired as a strategy to meet your philanthropic goals and realize tax savings. This article discusses the tax benefits and considerations of donating publicly traded shares that you received as a result of exercising your employee stock options.

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

### Stock option taxation

Generally, when you decide to exercise your public company employee stock options, you will realize a security options benefit. This benefit is equal to the difference between the fair market value (FMV) of the shares at the time you exercise the options and the amount you pay for the shares (the exercise price or strike price). The security options benefit is considered employment income and is taxable to you at your marginal tax rate.

You may be eligible for an offsetting security options deduction equal to 50% of your security options benefit, if certain conditions are met. For example, one of the conditions to be eligible for the security options deduction is if the exercise price was not less than the FMV of the shares at the time the options were granted. The deduction results in the security

options benefit being effectively taxed at capital gains rates.

Note that for Quebec provincial tax, the security options deduction is generally only 25%. You may be eligible for a security options deduction of 50% on your Quebec return for stock options granted under an agreement concluded after February 21, 2017, provided certain conditions are met. For further details, please ask an RBC advisor for our article on the taxation of employee stock options.

### Tax benefits of donating stock option shares

There are two tax benefits you will receive when donating your publicly listed stock option shares to a qualified donee. A qualified donee is an organization that can issue official donation receipts for gifts it receives. Typically, a registered charity

Assuming you qualify for the 50% security options deduction, you may receive an additional deduction if you donate your stock option shares.

is a qualified donee and includes a charitable organization, a public foundation or a private foundation. There are a number of other qualifying organizations which are not mentioned here.

#### 1) An additional deduction

Assuming you qualify for the 50% security options deduction, you may receive an additional deduction if you donate your stock option shares. In order to qualify for the additional deduction, you will need to donate the shares acquired on the exercise of your options in the same year you exercise the options and within 30 days of exercising the options. If you exercise your stock options in December, you will not have the full 30 days to make the donation as you must donate the shares before December 31st.

The amount of the additional deduction is equal to 50% of the lesser of two amounts:

- (1) The security options benefit
- (2) The FMV on the disposition minus the exercise price

If the stock option shares have remained the same or increased in value at the time of making your donation, the additional deduction effectively eliminates your security options benefit. Alternatively, if the shares have declined in value at the time of making your donation, your additional deduction is reduced proportionately. In other words, your additional deduction will be less than 50% of your security options benefit.

If you live in Quebec, on your Quebec provincial income tax return you will receive the additional deduction on top of your regular security options deduction, which may be 25% or 50%.

#### 2) A donation tax credit

In addition to eliminating or reducing your security options benefit, you will also receive a donation tax receipt

equal to the FMV of the shares you donate. This allows you to claim a donation tax credit which can be used to reduce the taxes payable on your other sources of taxable income.

#### Cashless exercises

If you have been granted employee stock options but do not have the cash needed to pay for the shares upon exercise of the options, you can consider a cashless exercise of your options. A cashless exercise involves short selling the underlying shares as a means of acquiring the cash needed to exercise the options. Generally, short selling is a speculative practice that involves using a broker to sell shares that you do not own.

Using some of the funds raised from the short sale, you exercise your stock options. The broker receives the shares from your employer and uses them to cover the short sale. The broker then pays you the difference between the cash received from the short sale and the cash used to exercise your stock options.

In a cashless exercise, if you direct the broker to immediately donate all or a portion of the proceeds to a qualified donee, you may still be eligible for a portion of the additional deduction. The deduction is prorated to reflect the proportion of the proceeds that you instruct the broker to donate and is determined by the following formula:

$$A \times B/C$$

A is the amount of the additional deduction that would have been available if the shares were acquired and then donated

B is the amount donated to charity by the broker

C is the total proceeds of disposition of the share acquired via the option.

Check with an RBC advisor to determine if you meet the requirements to execute a cashless exercise.

### An example

In September 2020, Kate exercises options to acquire 200 shares of her corporate employer. The exercise price is \$25 a share and the FMV at the time of acquisition is \$250 a share. She directs the broker, who is administering the stock option plan for her employer, to effect a cashless exercise and donate the net proceeds of \$45,000 to a registered charity. (The amount donated of \$45,000 is calculated as \$50,000 proceeds from the sale of shares, less \$5,000 paid to her employer to cover the exercise price.)

Kate has a security options benefit equal to \$45,000 (i.e., the FMV of the shares at the time of acquisition less

the exercise price). Kate is entitled to a security options deduction of \$22,500 (50% of \$45,000) since she meets all of the relevant criteria. If she had donated the shares to a registered charity, she would have been entitled to an additional deduction of \$22,500 (50% of \$45,000). But since she donated 90% of the proceeds from the disposition of the shares, she is entitled to deduct \$20,250 ( $\$22,500 \times \$45,000 / \$50,000$ ).

### Choosing the method of donation

Assume an executive has 1,000 options expiring next month. The exercise price is \$20 a share and the current FMV is \$50 a share. The executive and their spouse regularly make a cash donation at year-end

of \$50,000. If the executive chooses to use a cashless exercise, they will only be able to donate the net cash of \$30,000. In this case, the executive and their spouse will make an additional cash donation of \$20,000 by year-end to meet their annual donation goal. They are wondering if there is a more tax-efficient way to execute their charitable intentions.

The following illustration compares the tax implications of three different methods in which you can make a donation of your employee stock option shares. The illustration assumes the executive is in the highest marginal tax bracket and taxed at a rate of 50%:

|   | Exercise options, sell shares and donate \$50,000 cash | Exercise options and donate shares worth \$50,000 <sup>1</sup> | Cashless exercise of options and direct broker to donate \$30,000 cash |
|---|--|--|--|
| Value at exercise                                   | \$50,000   | \$50,000   | \$50,000   |
| Less: Exercise price                                | (\$20,000)   | (\$20,000)   | (\$20,000)   |
| Security options benefit                            | \$30,000   | \$30,000   | \$30,000   |
| Less: 50% security options deduction                | (\$15,000)   | (\$15,000)   | (\$15,000)   |
| Less: Additional deduction                          | NIL  | (\$15,000)   | (\$9,000) <sup>2</sup>   |
| <b>Net taxable income</b>                           | <b>\$15,000</b>  | <b>NIL</b>   | <b>\$6,000</b>   |
| Taxes payable @ 50% (a)                             | \$7,500  | NIL  | \$3,000  |
| Donation amount relating to stock options (b)       | \$50,000   | \$50,000   | \$30,000   |
| Additional cash donation (c)                        | NIL  | NIL  | \$20,000   |
| <b>Total donation</b>                               | <b>\$50,000</b>  | <b>\$50,000</b>  | <b>\$50,000</b>  |
| Donation tax credit <sup>3</sup> (d)                | \$25,000   | \$25,000   | \$25,000   |
| Tax savings (d) – (a)                               | \$17,500   | \$25,000   | \$22,000   |
| <b>Total cost of donation (a) + (b) + (c) – (d)</b> | <b>\$32,500</b>  | <b>\$25,000</b>  | <b>\$28,000</b>  |

1) Donation is made in the same year and within 30 days after exercising the options

2)  $\$15,000 \text{ additional deduction} \times (\$30,000 \text{ donation} / \$50,000 \text{ proceeds of disposition})$

3) Assumed the executive has sufficient taxable income so that the donation tax rate is 50%. The calculation does not consider the lower donation tax rate on the first \$200.

Based on the above illustration, exercising options and donating the shares to a registered charity is the most tax-efficient option. The executive would save \$7,500 (\$32,500-\$25,000) by donating \$50,000 of shares instead of \$50,000 of cash due to the additional deduction. The executive would also save \$3,000 (\$28,000-\$25,000) by donating \$50,000 of shares instead of choosing a cashless exercise and directing the broker to donate the net proceeds. This is because the additional deduction is prorated in the case of a cashless exercise. That said, if the executive does not have all the necessary funds to exercise their options, a cashless exercise may be better than having the options expire and not having any funds to donate.

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### Stock option donation calculator

In many cases, you may not want to donate all of the shares you acquire from exercising your stock options. You may wish to donate some of the shares and sell the remaining portion. In this case, the donation tax credit on the portion of the shares that you donate can reduce the tax liability on the remaining security options benefit that is not eliminated.

This begs the question, what portion of your shares do you need to donate so that the tax on the entire security options benefit is eliminated? To answer this question, ask an RBC advisor about the stock option donation calculator. This tool can help you determine the specific number of shares you need to donate in order to eliminate the taxes payable on the security options benefit.

### Conclusion

If you intend to donate to charity, consider donating the shares you acquired by exercising your employee stock options. Not only is it a great way to reduce your out-of-pocket donation cost, but you also may be able to eliminate your entire tax liability on the exercise of your options. Speak to a qualified tax advisor to determine if this strategy is right for you to help meet your philanthropic goals in the most tax-efficient way.

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