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The Montréal Exchange brings you the first issue of its Options Newsletter for Investment Advisors. Targeted to professional traders and investment dealers approved for options trading, this newsletter will cover subjects that will help you discussing options with your clients and on the MX options market.

In this issue:

- The tax treatment of equity options
- The new options symbology

The Tax Treatment of Equity Options

The tax treatment of equity options is a source of preoccupation for many investors. The most frequent questions can be:

- Are options transactions treated as capital gains or as income?
- Is there a different treatment for holding options compared to selling them?
- In which taxation year should we declare profits and losses from the sale (writing) of options? Is it based on the selling date or related to the expiration date or the date of the closing transaction?

You will find the answers to these questions in the “Equity Options Tax Regime” document written by the firm KPMG and published by the Montréal Exchange. Here is a review.

The first step consists in determining if the options transactions should be considered as capital gains or as business income. This distinction can be difficult to do at times but as a rule of thumb, consistency in the use of the same method from year to year should reduce the risk of a challenge by the tax authorities.

Options are defined as securities and, as such, profits and losses are generally considered on the same account as those realized on the corresponding underlying shares by the Canada Revenue Agency (CRA). The treatment is the same for profits or losses realized by the holder or by the writer of options.

So, if the profits or losses realized by your clients are already treated as capital gains, then all their options transactions will be treated the same by the CRA.

The second step consists in determining when the profits or the losses should be recognized for income tax purposes. There are four important points to consider for income tax purposes when trading options:

1. the initial purchase or sell date
2. the date when the option is exercised
3. the expiration date if the option is not exercised (i.e. the option has expired worthless)
4. the date of the closing transaction (selling or buying back the options)

Capital gains or losses – Potential situations

		Exercise	Nonexercise (options expire worthless)	Closing of the positions (selling or buying back)
Holder	Calls and puts	Adjusted cost base = Premium + Strike price	Loss is equal to the premium and recognized in the taxation year in which the option expires.	Loss or gain recognized in the taxation year in which the option is sold.
Writer	Calls and puts	At first, the initial sale is considered as capital gain in the taxation year in which the option is sold. Profit = Premium	Profit is equal to the premium and is recognized in the taxation year in which the option is sold	The profit is recognized in the taxation year in which the option is sold and the loss in the taxation year in which the option is bought back
	Calls	Exercise in the same taxation year as the initial selling transaction The capital gain is reduced to nil and the premium is added to the proceeds from the disposition of the shares. Exercise in a different taxation year then the initial selling transaction The capital gain is reduced to nil and a tax return amendment must be filed to cancel the capital gain for the previous year. The premium is added to the proceeds from the disposition of the shares.	N/A	N/A
	Puts	Exercise in the same taxation year as the initial selling transaction The capital gain is reduced to nil and the premium is deducted from the cost of the shares acquired. Exercise in a different taxation year then the initial selling transaction The capital gain is reduced to nil and a tax return amendment must be filed to cancel the capital gain for the previous year. The premium is deducted from the cost of the shares acquired.	N/A	N/A

Income transactions

Generally speaking, for investors which transactions qualify as business income, the income or the loss of the holder (or the writer) will only be recognized when the position is closed (i.e. either when the option is exercised, expires, is sold or bought back).

Please take note the examples used above are informative and general in nature and cannot replace the advice of a qualified tax adviser. Thus, we recommend you get individual advice adapted to the specific needs of your clients from an independent source.

For more information

Equity Options Tax Regime

http://www.m-x.ca/f_publications_en/brochure_fiscalite_kpmg_en.pdf

The New Options Symbology

February 12, 2010 marked the implementation of the new options symbology. To coincide with the Options Symbology Initiative (OSI) being implemented in the United States by the Options Clearing Corporation (OCC), a joint Bourse de Montréal (the Bourse)/Canadian Derivatives Clearing Corporation (CDCC) projet was launched to adapt and modify all Canadian option series to coincide with the model being used at the OCC.

The new symbology replaces the actual 5 alpha character symbol with an improved 21 alphanumerical symbol which will allow expanding the option symbol by providing explicit expiry dates and option type information (call or put). This will enable most options to share the same root symbol as the underlying security symbol. Barring exceptions, we should see the elimination of root symbol duplication related to identifying long-term equity options, as well as the elimination of multiple symbols because of the lack of alphabetical character to identify fully all the strike prices. Finally, the new symbology provides the flexibility for the development of new products in the derivatives market.

The symbology initiative impacts the equity, index and foreign currency options while all other derivatives maintain the current symbology.

Quote vendors and brokers are not impacted uniformly by the OSI. Consequently, it is recommended that you take note of the impact the OSI could have on the publication, by your firm, of the different reports to your clients following its implementation.

For more information

Options symbology initiative FAQ

http://www.m-x.ca/f_publications_en/faq_symbologie_en.pdf