MONTRÉAL EXCHANGE

Equity Options Tax Regime

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This document was written by KPMG LLP. Information in this issue is current to August 31, 2011.

The use of the masculine gender in this document is intended to simplify its content and designates women as well as men.

Equity Options Tax Regime

The purpose of this guide is to provide a general overview of the Canadian income tax treatment of equity option transactions for individual Canadian investors.

Part one of the guide addresses the characterization of gains and losses realized by the investor as being either on "income account" (business income), or on "capital account" (capital gain or loss). Part two discusses when the gains or losses realized by the investor are recognized for income tax purposes. Part three deals with registered retirement savings plans ("RRSPs") and tax-free savings accounts ("TFSAs") and indicates which equity option transactions can be carried out within such plans. Finally, part four provides a number of examples illustrating the tax treatment of common equity option strategies.

This document is of a general nature and the reader is invited to obtain individual advice adapted to his own situation from an independent source.

1. Tax Characterization of Gains and Losses on Options

1.1. Relevance of the Distinction

The first step in determining the tax consequences of an option transaction consists in establishing whether the transaction is on account of income or capital. This distinction has material tax implications, notably:

- In the case of a gain or loss resulting from a transaction on income account, the full amount of the gain or loss must be recognized for tax purposes. In the case of a gain or loss arising from a capital transaction, only one-half of the gain is taxable and must be included in income; similarly, only one-half of the loss constitutes a deductible capital loss.
- Losses arising from income transactions can be used to offset income from any source, such as business income, employment income, or capital gains, whereas deductible capital losses can only be used to offset taxable capital gains. Moreover, deductible losses arising from income transactions that cannot be deducted within the year may be used to offset taxable income realized in the three preceding taxation years or the twenty subsequent taxation years, whereas deductible capital losses that cannot be deducted within the year can be used to offset taxable capital gains realized in the three preceding taxation years or any subsequent taxation year. [1]

There is no clear-cut rule for characterizing a particular transaction as being on income or capital account. The criteria most frequently used by the Canada Revenue Agency ("CRA") for characterizing option transactions are discussed below. Adopting a consistent approach (i.e. maintaining the same characterization from year to year) helps reduce the risk of a challenge by the CRA.

1.2. Capital Transactions

The CRA generally presumes that: a) the gain or loss realized by a an option holder is on the same account as the holder's transactions in shares; and b) the gain or loss realized by a writer of covered options is on the same account as the underlying shares. [2]

A "capital property" is a property whose sale results in a capital gain. However, there is no specific definition of "capital property" in the Income Tax Act [3] (hereafter "the Act" or "ITA"). Nevertheless, if it can be concluded, after analyzing the criteria described in section 1.3 below, that a taxpayer's option transactions are not on income account, then the taxpayer will generally be allowed to report his option gains and losses on capital account.

Accordingly, one-half of the gains or losses will be included or deducted [4] in computing the taxpayer's income for a given taxation year.

Subject to certain exceptions, a taxpayer who is not a "trader or dealer in securities" may make an irrevocable election in his income tax return that all Canadian securities he owns in that year and in any subsequent year be treated as capital property. [5] A "trader or dealer in securities" is generally a taxpayer who makes it a profession or a business of buying and selling securities. It is a question of fact to determine whether one's activities amount to carrying on a trade or business. Factors such as the frequency of the transactions, the duration of the holdings, the intention to acquire for resale at a profit, the nature and quantity of the securities held or made the subject matter of the transaction, the time spent on the activity, are all relevant and helpful factors in determining whether one has embarked upon a trading or dealing business. [6]

1. Non-capital losses realized in taxation years ending after December 31, 2005 can be carried forward twenty years. However, the carryforward of losses realized in taxation years ending from March 23, 2004 through to December 31, 2005 is limited to ten years, and the carryforward of losses realized in taxation years ending prior to March 23, 2004 is limited to seven years.
2 CRA, *Interpretation Bulletin* IT-479R, "Transactions in securities", February 29, 1984, para. 25 (hereafter "Bulletin IT-479R").
3 *Income Tax Act, R.S.C. 1985 (5th supp.)* c. 1, as amended.
4 Capital losses can be used to offset capital gains realized in the same taxation year, or in the three preceding taxation years or any subsequent taxation year (paras. 3(b) and 111(1)(b) ITA).
5 Ss. 39(4) ITA. This election is made by the taxpayer by filing form T123 – *Election on disposition of Canadian securities.* Quebec residents will also have to file form TP-250.1 – *Election respecting the disposition of Canadian securities.* This election may not be made by a taxpayer who is: a trader or dealer in securities, a financial institution, a non-resident and a corporation whose principal business is the lending of money or the purchasing of debt obligations or a combination thereof.
6 See generally *Vancouver Art Metal Works Limited v. R.*, 93 DTC 5116 (FCA).

Even though the irrevocable election applies to Canadian securities and not equity options, [7] a taxpayer who makes such election in regard to his share transactions will also be deemed to be trading options on capital account given the CRA's aforementioned presumption that: a) the gain or loss realized by an option holder is on the same account as his transactions in shares; and b) the gain or loss realized by a writer of covered options is on the same account as the underlying shares. [8]

The above-mentioned presumption may not apply to unusual situations such as where an option holder usually trades shares on income account (i.e. the option holder did not make the election concerning the disposition of Canadian securities), but also holds a separate group of shares for investment purposes on capital account. In this situation, option transactions with respect to the former group should be treated as income transactions and the ones regarding the latter as capital transactions. [9]

1.3. Capital Transactions

The CRA generally recognizes that individual investors displaying one of the following characteristics will have to report their option-related gains or losses as business income:

a. The transactions are that of a taxpayer who holds himself out to the public as a trader or dealer in securities; [10]

b. The transactions are made by a taxpayer using special information not available to the public to realize a quick profit; [11]

c. The transactions are part of the "whole course of conduct" of the taxpayer and are carried on in the same way as those of a trader or dealer in securities. Some of the factors to be considered in establishing whether the taxpayer's course of conduct indicates the carrying on of a business are as follows: [12]

    1. extensive buying and selling of securities;
    2. securities usually owned only for a short period of time;
    3. knowledge or experience of securities markets;
    4. security transactions form a part of a taxpayer's ordinary business;
    5. a substantial part of the taxpayer's time is spent studying the securities markets and investigating potential purchases;
    6. security purchases are financed primarily on margin or by some other form of debt; and
    7. the taxpayer has advertised or otherwise made it known that he is willing to purchase securities.

In these circumstances, the sale proceeds of options will be treated as business income for tax purposes and will have to be reported accordingly on the income tax return.

Finally, the CRA generally presumes that the gain or loss realized by a writer of naked options is normally on income account. However, the CRA will accept the reporting of gains and losses on capital account provided that this practice is followed consistently from year to year [13] and that the taxpayer does not fall into one of the three categories mentioned above.

7. A call or put option is not a Canadian security pursuant to ss. 39(6) ITA.
8 *Supra* note 2.
9 *Ibid.*
10 *Ibid.* at paras. 3 and 5. The concept of "trader or dealer in securities" is discussed in section 1.2, above.
11 *Ibid.* at para. 17.
12 *Ibid.* at paras. 10 and 11.
13 *Ibid.* at para. 25.

2. Tax Treatment of Gains and Losses on Options

2.1. Capital Transactions

Capital transactions involving options are subject to specific provisions of the Act.[14] These provisions create a regime giving rise to tax consequences at the time options are written [15] and at the time options are exercised, sold, closed out, or left to expire. Let's consider each of these possibilities.

2.1.1. Call Options

IF THE OPTION IS EXERCISED

HOLDER:

At the time the option is acquired, the holder is deemed to acquire a property whose cost is equal to the premium paid. At the time the option is exercised, the cost of acquiring the option is added to the cost of the underlying shares.[16]

(See section 4.2 hereafter for an example of this situation)

WRITER:

During the taxation year that the option is written, the writer is deemed by the Act to have disposed of a property whose adjusted cost base [17] is nil, realizing a capital gain equal to the amount by which the premium received exceeds any brokerage fees. [18]

However, when the option is exercised, the previously-included capital gain is reduced to nil [19] and the proceeds from the option are added to the proceeds from the disposition of the underlying shares, resulting in a capital gain or loss for the writer. [20]

(See section 4.3 hereafter for an example of this situation)

IF THE OPTION EXPIRES UNEXERCISED

HOLDER:

At the time the option is acquired, the holder is deemed to acquire a property whose cost is equal to the premium paid. The cost of acquiring the option is treated as a capital loss for the holder in the taxation year in which the option expires. [21]

(See section 4.2 hereafter for an example of this situation)

WRITER:

During the taxation year that the option is written, the writer is deemed by the Act to have disposed of a property whose adjusted cost base is nil, resulting in a capital gain equal to the amount by which the premium received exceeds any brokerage fees. [22]

(See section 4.3 hereafter for an example of this situation)

IF THE OPTION IS SOLD BY THE HOLDER

HOLDER:

At the time the option is acquired, the holder is deemed to acquire a property whose cost is equal to the premium paid. The net gain or loss realized on the acquisition and subsequent disposition of the option is a capital gain or capital loss in the taxation year in which the option is sold. [23]

(See section 4.1 hereafter for an example of this situation)

IF THE OPTION IS CLOSED OUT BY THE WRITER

WRITER:

During the taxation year in which the option is sold, the writer is deemed by the Act to have disposed of a property whose adjusted cost base is nil, resulting in a capital gain equal to the amount by which

the proceeds of the option exceed any costs of disposition. The cost of purchasing an offsetting position constitutes a capital loss in the taxation year of this acquisition. [24]

14 S. 49 ITA.
15 It should be noted that the ITA and the tax publications issued by the CRA generally use the expression "granting" of option to designate the writing of an option.
16 Subpara. 49(3)(b)(ii) ITA.
17 The adjusted cost base is the concept used to calculate the capital gain and will generally be equal to the cost of the property.
18 Ss. 49(1) ITA.
19 If the call option is exercised in a subsequent taxation year, the writer must file an amended tax return for the taxation year in which the option was written excluding the capital gain from income by using forms T1-ADJ – *T1 adjustment request (federal)* and TP-1.R - *Request for an Adjustment to an Income Tax Return* (Quebec).
20 Para. 49(3)(a) ITA.
21 Para. (d) of the definition of "superficial loss" in sec. 54 ITA; subpara. (b)(iv) of definition of "disposition" in ss. 248(1) ITA. 22 Ss. 49(1) ITA.
23 Paras. 39(1)(a) and 39(1)(b) ITA.
24 Bulletin IT-479, para. 29.

2.1.2. Put Options

IF THE OPTION IS EXERCISED

HOLDER:

At the time the option is acquired, the holder is deemed to acquire a property whose cost is equal to the premium paid. The cost of acquiring the option is deducted from the proceeds of disposition of the underlying shares. [25]

(See section 4.4 hereafter for an example of this situation)

WRITER:

The writer is deemed by the Act to have disposed of a property whose adjusted cost base is nil in the taxation year in which the option is sold, resulting in a capital gain equal to the amount by which the premium received exceeds any brokerage fees. [26]

However, in the taxation year the option is exercised, this capital gain is reduced to nil [27] and the proceeds of disposition of the option are deducted from the cost of the underlying shares acquired as a result of the exercise of the option. [28]

(See section 4.5 hereafter for an example of this situation)

IF THE OPTION EXPIRES UNEXERCISED

HOLDER:

At the time the option is acquired, the holder is deemed to acquire a property whose cost is equal to the premium paid. The cost of the option is treated as a capital loss in the taxation year in which the option expires. [29]

(See section 4.4 hereafter for an example of this situation)

WRITER:

The writer is deemed by the Act to have disposed of a property whose adjusted cost base is nil in the taxation year in which the option is sold, resulting in a capital gain equal to the amount by which the premium received exceeds any brokerage fees. [30]

(See section 4.5 hereafter for an example of this situation)

IF THE OPTION IS SOLD BY THE HOLDER

HOLDER:

At the time the option is acquired, the holder is deemed to acquire a property whose cost is equal to the premium paid. The net gain or loss realized on the acquisition and subsequent disposition of the option is a capital gain or capital loss in the taxation year in which the option is sold. [31]

(See section 4.1 hereafter for an example of this situation)

IF THE OPTION IS CLOSED OUT BY THE WRITER

WRITER:

The writer is deemed by the Act to have disposed of a property whose adjusted cost base is nil in the taxation year in which the option is sold, resulting in a capital gain equal to the amount by which the premium received exceeds any brokerage fees. The cost of the offsetting option must be computed as a loss at the time of the acquisition. [32]

25 Para. 49(3.1)(a) ITA.
26 Ss. 49(1) ITA.
27 If the option is exercised in a subsequent taxation year, the writer must file an amended tax return for the taxation year in which the option was written excluding the capital gain from income by using forms T1-ADJ – *T1 adjustment request (federal)* and *TP-1.R - Request for an Adjustment to an Income Tax Return* (Quebec).
28 Para. 49(3.1)(b) ITA.
29 Supra note 21
30 Ss. 49(1) ITA.
31 Paras. 39(1)(a) and 39(1)(b) ITA.
32 Bulletin IT-479R, par. 32.

2.2. Income Transactions

The Act does not contain any specific provision dealing with the computation of income derived from equity option transactions. However, certain administrative rules are provided in Bulletin IT-479R.

Generally, the income or loss of the option writer or holder will not be recognized before his position is closed out, i.e. either when the option is exercised, expires, is sold, or when an offsetting position is acquired. Any income or loss must be entirely accounted for (contrary to a capital gain or loss for which only one-half of the gain or loss is accounted for).

2.2.1. Call Options

IF THE OPTION IS EXERCISED

HOLDER:

In this situation, the holder actually acquires the underlying shares. The premium and brokerage fees incurred at the acquisition date are added to the cost of acquiring the underlying shares. Therefore, the premium and brokerage fees paid will reduce the income (or increase the loss) of a subsequent sale of the underlying shares.

(See section 4.2 hereafter for an example of this situation)

WRITER:

The premium received must be included in the writer's income in the taxation year in which the option is exercised. Moreover, the writer will incur a gain or a loss on account of income resulting from the sale of the underlying shares upon the exercise of the option.

(See section 4.3 hereafter for an example of this situation)

IF THE OPTION EXPIRES UNEXERCISED

HOLDER:

The cost of acquiring the option must be deducted in computing the income in the taxation year in which the option expires.

(See section 4.2 hereafter for an example of this situation)

WRITER:

The premium must be included in computing the income in the taxation year in which the option expires.

(See section 4.3 hereafter for an example of this situation)

IF THE OPTION IS SOLD BY THE HOLDER

HOLDER:

The proceeds of sale must be included in income and the original cost of acquiring the option must be deducted from income in the taxation year in which the option is sold.

(See section 4.1 hereafter for an example of this situation)

IF THE OPTION IS CLOSED OUT BY THE WRITER

WRITER:

The premium received from writing the option must be deducted from the acquisition cost of the

offsetting option and the resulting loss or gain must be included in income in the taxation year in which the option is closed out.

2.2.2. Put Options

IF THE OPTION IS EXERCISED

HOLDER:

In this case, the holder actually disposes of the underlying shares. The premium and brokerage fees paid for the option at the time of acquisition are deducted from the proceeds of the underlying shares. Therefore, the premium and brokerage fees reduce the income (or increase the loss) on the sale of these shares.

(See section 4.4 hereafter for an example of this situation)

WRITER:

The premium received for the option must be deducted from the cost of the shares acquired under the option.

(See section 4.5 hereafter for an example of this situation)

IF THE OPTION EXPIRES UNEXERCISED

HOLDER:

The cost of acquiring the option must be deducted from income in the taxation year in which the option expires.

(See section 4.4 hereafter for an example of this situation)

WRITER:

The premium must be added to income in the taxation year in which the option expires.

(See section 4.5 hereafter for an example of this situation)

IF THE OPTION IS SOLD BY THE HOLDER

HOLDER:

The proceeds of sale must be included in income and the original cost of acquiring the option must be deducted from income in the taxation year in which the option is sold.

(See section 4.4 hereafter for an example of this situation)

IF THE OPTION IS CLOSED OUT BY THE WRITER

WRITER:

The premium received from writing the option must be deducted from the acquisition cost of the offsetting option and the resulting loss or gain must be included in income in the taxation year in which the option is closed out.

3. Registered Retirement Savings Accounts and Tax-Free Savings Accounts

A variety of option transactions can be carried out within a registered retirement savings plan ("RRSP") or tax-free savings account ("TFSA").

Securities, including options, listed on a designated stock exchange such as the Montréal Exchange generally constitute a "qualified investment" for RRSP [33] and TFSA [34] purposes, subject to the following exceptions:

(i) futures contracts, and (ii) derivative instruments in respect of which the holder's risk or loss may exceed the holder's cost. [35] Thus, call options and put options may be purchased within an RRSP or TSFA given that the holder's risk of loss on such options does not exceed the holder's cost of acquiring the options.

In addition, as the writing of a put option or call option does not result in an acquisition of property (merely an obligation to buy or sell the property at the agreed-upon price should the option holder so require), the issue of whether such an option is a "qualified investment" is not relevant. [36] However, the CRA has indicated that the writing of a naked call or of a put option may result in a plan trust being considered to be carrying on a business, with the result that the plan trust would become liable to tax with respect to the income from such activities. [37]

In sum, the following equity option transactions may be carried out within an RRSP or TSFA:

- purchasing call options;
- purchasing put options;
- writing put options; and
- writing covered call options.

4. Examples Based on Common Option Strategies

The Montréal Exchange has published a guide entitled *Reference Manual – Equity Options*. The last chapter of that Guide presents and discusses, through a series of examples, different equity option trading strategies. The income tax consequences of some of these strategies are described below.

4.1. Buying Call Options Instead of Buying Stocks

An investor feels that the shares of MNO Bank, which are trading at $16.00, are undervalued. He does not own any MNO Bank shares but believes that they will rise over the coming months. The investor decides to buy two MNO OCT 17 call options, currently trading at $0.75, for a total cost of $150.00 (i.e. 2 x 100 x $0.75).

Six months later, MNO Bank stock has indeed risen, closing at $20.00. The MNO OCT 17 call options are now selling for a premium of $3.00. Feeling that MNO Bank stock is not likely to rise further, the investor decides to sell his two MNO OCT 17 call options for $600.00 (2 x 100 x $3.00).

33 Para. (a) of the definition of "qualified investment" in ss. 146(1) ITA.
34 Para. (a) of the definition of "qualified investment" in ss. 207.01(1) ITA.
35 Para. (d) of the definition of "qualified investment" in ss. 204(1) ITA.
36 CRA, *Interpretation Bulletin IT-320R3*, "Qualified Investments - Trusts Governed by Registered Retirement Savings Plans, Registered Education Savings Plans and Registered Retirement Income Funds", July 1, 2002, para. 22.
37 *Ibid.* at para. 23 and CRA, *Technical Interpretation 2010-0364811e5 – Options*, February 8, 2011.

SCENARIO

Buy two MNO OCT 17 calls at $0.75:	$150.00
Sell two MNO OCT 17 calls at $3.00:	$600.00
Net profit:	$450.00

CAPITAL ACCOUNT TRANSACTION:
Taxable capital gain of $225.00 in computing income for the year in which the options are sold ($450.00 x ½).

INCOME ACCOUNT TRANSACTION:
Inclusion of $450.00 in computing income for the year in which the options are sold.

4.2. Buying Call Options as Protection for Future Purchases

An investor finds the shares of ABC Inc. at a price of $21.00 to be an excellent portfolio investment for the long term. On the other hand, the investor is concerned that the share price may rise considerably over the next few months such that the purchase of ABC stock might cost considerably more than $21.00 per share at the time he will be in a position to purchase them.

The investor purchases ABC OCT 20 call options at a premium of $2.00, setting an actual ceiling price of $22.00 (strike price plus premium) for ABC stock at any time until the third Friday of October.

SCENARIO 1: ABC'S STOCK PRICE RISES TO $24.00 AND THE OPTION IS EXERCISED.

Buy one ABC OCT 20 call at $2.00:	$200.00
Buy 100 ABC shares at $20.00 (option exercised):	$2,000.00

CAPITAL ACCOUNT TRANSACTION:
Addition of $200.00 to the acquisition cost of the underlying shares; therefore a total cost of $2,200.00 for the 100 ABC shares ($2,000.00 + $200.00).

INCOME ACCOUNT TRANSACTION:
Addition of $200.00 to the acquisition cost of the underlying shares, therefore a total cost of $2,200.00 for the 100 ABC shares ($2,000.00 + $200.00).

SCENARIO 2: ABC'S STOCK PRICE FALLS BELOW $20.00.
If, at the options' expiry, the stock price of ABC Inc. is below $20.00 and the option is not exercised, the investor will incur a loss equal to the premium paid to acquire this option.

Buy one ABC OCT 20 call at $2.00:	$200.00

CAPITAL ACCOUNT TRANSACTION:
Allowable capital loss of $100.00 sustained at the expiry date (200.00 x ½).

INCOME ACCOUNT TRANSACTION:
Income deduction of $200.00 at the expiry date.

4.3. Writing Covered Call Options

An investor holds one hundred shares of ABC priced at $14.00 and decides to write one ABC JUN 15 call option at a premium of $0.50.

The investor protects his ABC shares against moderate declines in share price down to $13.50 (i.e. $14.00 - $0.50) since losses on his stock position will be offset by the option premium received.

SCENARIO 1: ABC'S STOCK PRICE RISES ABOVE $15.00.

If the price of ABC shares increases, the investor may indeed find his shares "called" by the investor who bought the call option. In this case, the call option writer will realize a net effective selling price of $15.50 per share, that is, the strike price of $15.00 plus the $0.50 premium received on April 19.

Sell one ABC JUN 15 call at $0.50:	$50.00

CAPITAL ACCOUNT TRANSACTION:
Taxable capital gain of $25.00 in computing income for the year in which the option is written ($50.00 x ½).

For the year in which the option is exercised, addition of $50.00 to the proceeds from the underlying shares and cancellation of the capital gain realized in the year in which the option is written.

INCOME ACCOUNT TRANSACTION:
Inclusion of $50.00 in computing income for the year in which the option is exercised.

SCENARIO 2: ABC'S STOCK PRICE STAYS BELOW $15.00.

If the share price is stable and remains below $15.00, the investor will retain all of his call option premium income (and the option will not be exercised).

Sell one ABC JUN 15 call at $0.50:	$50.00

CAPITAL ACCOUNT TRANSACTION:
Taxable capital gain of $25.00 in computing income for the year in which the option is written ($50.00 x ½).

INCOME ACCOUNT TRANSACTION:
Inclusion of $50.00 in computing income for the year in which the option expires.

4.4. Buying Put Options as an Insurance Policy (Protective Puts)

An investor holds 1,000 shares of MNO Bank. The MNO shares have increased substantially in value since the investor acquired them at $20.00 and are now worth $32.00 per share or $32,000.00 (1,000 x $32.00).

To hedge his MNO stocks, the investor purchases ten MNO JUN 32 put options at a premium of $1.60 per share or $1,600.00 in total for the ten options. He therefore secures a selling price of $30.40 per share (i.e. strike price of $32.00 less premium paid of $1.60) if MNO stock drops in value.

SCENARIO 1: MNO'S STOCK PRICE FALLS TO $26.00 AND THE PUT OPTIONS CAN BE SOLD AT A PREMIUM OF $6.00.

The loss of $6.00 per share on the drop in stock price is partially offset by an option profit of $4.40 (i.e. $6.00 - $1.60) if the investor sells ten put options.

Buy ten MNO JUN 32 puts at $1.60:	$1,600.00
Sell ten MNO puts at $6.00:	$6,000.00
Net Profit:	$4,400.00

CAPITAL ACCOUNT TRANSACTION:
Income inclusion of a taxable capital gain of $2,200.00 for the year in which the options are sold (4,400.00$ x ½).

INCOME ACCOUNT TRANSACTION:
Income inclusion of $4,400.00 for the year in which the options are sold.

SCENARIO 2: MNO'S STOCK PRICE INCREASES TO $40.00.

In this case, the ten put options would be worthless and expire without being exercised.

Buy ten MNO JUN 32 puts at $1.60:	$1,600.00

CAPITAL ACCOUNT TRANSACTION:
Deductible capital loss of $800.00 for the year in which the options expire ($1,600.00 x ½).

INCOME ACCOUNT TRANSACTION:
Deduction of $1,600.00 in computing taxable income for the year in which the options expire.

SCENARIO 3: MNO'S STOCK PRICE FALLS TO $26.00 AND THE INVESTOR EXERCISES THE TEN PUTS.

Buy ten MNO JUN 32 puts at $1.60:	$1,600.00
Sell 1,000 MNO shares at $32.00 (option exercised):	$32,000.00

CAPITAL ACCOUNT TRANSACTION:
The options' acquisition cost of $1,600.00 is deducted from the proceeds from the sale of the shares. For tax purposes, these proceeds will be equal to $30,400.00 resulting in a taxable capital gain of $5,200.00 (i.e. one-half of the difference between $30,400.00 and $20,000.00) for the year in which the options are exercised.

INCOME ACCOUNT TRANSACTION:
The options' acquisition cost of $1,600.00 is deducted from the proceeds from the sale of the shares.

For tax purposes, these proceeds will be equal to $30,400.00 resulting in an income of $10,400.00 (i.e. the difference between $30,400.00 and $20,000.00) for the year in which the options are exercised.

4.5. Writing Secured Put Options

XYZ shares are trading at $27.00. An investor feels the shares are slightly overvalued and decides to write put options with a strike price of $27.00. Accordingly, the investor writes ten XYZ JUN 27 put options at a premium of $1.15 per share. His proceeds from the sale are $1,150.00.

SCENARIO 1: XYZ'S STOCK PRICE DROPS BELOW $27.00.

On the date that the put options are set to expire, XYZ shares are trading at $26.00. The holder of the ten XYZ JUN 27 puts decides to exercises his options, and the investor is "assigned" to take delivery of 1,000 XYZ shares at $27.00.

Sell ten XYZ JUN 27 puts at $1.15:	$1,150.00
Buy 1,000 XYZ shares at $27.00 (option exercised):	$27,000.00

CAPITAL ACCOUNT TRANSACTION:
Taxable capital gain of $575.00 in computing income for the year in which the options are written ($1,150.00 X ½).

For the year in which the options are exercised, deduction of $1,150.00 from the cost of shares to be purchased, and cancellation of the capital gain realized in the year in which the options were written.

INCOME ACCOUNT TRANSACTION:
The premium of $1,150.00 received by the investor must be deducted from the cost of the shares to be purchased (net cost of $25,850.00 (i.e. $27,000.00 - $1,150.00) for 1,000 XYZ shares).

SCENARIO 2: XYZ'S STOCK PRICE STAYS ABOVE $27.00.

In this case, the ten puts are worthless and expire without being exercised.

Sell ten XYZ JUN 27 puts at $1.15:	$1,150.00

CAPITAL ACCOUNT TRANSACTION:
Taxable capital gain of $575.00 in computing income for the year in which the options are written ($1,150.00 x ½).

TRANSACTION AU TITRE DE REVENU :
Inclusion of $1,150.00 in computing income for the year in which the options expire.

5. Conclusion

As mentioned at the onset, the Canadian tax treatment of equity option transactions entered into by individuals is comprised of two fundamental elements. The first is the characterization of gains and losses realized by the taxpayer as either being on "income account" (business income) or on "capital account" (capital gain or loss) and the second is the determination of the moment at which the gains or losses realized by the taxpayer must be recognized for tax purposes.

Moreover, even in situations that are seemingly straightforward, it may be difficult to determine the tax consequences of equity option transactions, particularly in regards to the characterization of gains and losses as being on income account or capital account. As a result, the reader is invited to obtain individual advice adapted to his own situation from an independent source.

This document is of general nature and cannot serve as a substitute for the advice of a qualified tax adviser.

This document is updated as of August 31, 2011 and reflects the state of the Act at this date as well as the proposed amendments that are publicly known as of that date.

For more information

Please contact Montréal Exchange if you have any additional questions or require further clarification.

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