



## Wealth Management Services

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### Charitable Donation of Employee Stock Options

A strategy to eliminate tax on the exercise of your employee stock options

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*If you are an executive with employee stock options and you make annual cash donations to your favorite charity or have been thinking about how to leave a legacy, then you should be aware of a powerful tax strategy using your employee stock options based on new tax rules announced in the May 2, 2006 Federal Budget.*

#### The Basics

Normally, when you exercise your public company employee stock options and then immediately sell the stock acquired, your T4 employment income will increase by an amount equal to the gain in the employer stock from the strike price to the market value at exercise (i.e. the "stock option benefit"). You then may be eligible to deduct 50% of this stock option benefit on line 249 of your T1 income tax return if your strike price is equal to or greater than the fair market value of the employer stock when the options were granted. This means if you qualify for this deduction, you only have to pay tax on 50% of the stock option benefit at your marginal tax rate. Ultimately, this results in a top tax rate on your stock option benefit similar to the top capital gains tax rate (varies by provinces but approximately 19-24%). For the purposes of this document, it is assumed that you will qualify for this 50% stock option deduction.

Note that for Quebec tax purposes, the stock option deduction is only 25% of your stock option benefit.

#### The New Rules

As a result of changes announced in the May 2, 2006 Federal Budget, you can now receive an additional 50% deduction against the stock option benefit on top of the normal 50% deduction (for a total deduction of 100%) if you donate your public company shares directly to a charity (but not a private foundation) **in the same year of exercise and within 30 days after exercise**. This 100% deduction will have the effect of eliminating the tax on the stock option benefit.

For Quebec tax purposes, you will receive an additional 25% deduction against the stock option benefit on top of the normal 25% deduction (for a total deduction of 50%) if you donate your public company shares directly to a charity (but not a private foundation) in the same year of exercise and within 30 days of exercise. It is unclear if Quebec will increase this additional tax deduction in light of the new federal tax rules.

In addition to reducing the tax on your stock option benefit you will also receive a donation tax receipt equal to the fair market value of the shares donated. This donation receipt can be used to reduce the tax payable on other taxable income generally dollar for dollar. For example a donation receipt equal to \$10,000 means that you do not have to pay tax on approximately \$10,000 of your compensation.

**The key to this strategy is that the donation must be made in the same year of exercise and within 30 days of exercise.** If you expect to make donations during the year (especially near year

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end) and you have options that are expiring this year, then consider donating a portion of the stock acquired upon exercise to fulfill your annual charitable giving goals in order to reduce your out-of-pocket donation cost.

The following numerical example illustrates the tax benefit of donating stock in the same year and within 30 days of exercise compared to exercising the options, selling the stock and donating the cash. Assume an executive resident in Ontario has 1,000 options expiring next month (will not be a cash-less exercise) with a strike price of \$20 per share and a market value at exercise of \$50 per share. The executive regularly makes cash donations every year at year-end of approximately \$50,000 and is wondering the best way to donate this amount.

	<b>Exercise, sell stock and donate \$50,000 of cash at year-end</b>	<b>Exercise and donate \$50,000 worth of stock in same year and <u>within</u> 30 days of exercise</b>
Value at exercise (a)	\$50,000	\$50,000
Strike price	<u>(\$20,000)</u>	<u>(\$20,000)</u>
Stock option benefit	\$30,000	\$30,000
Normal 50% stock option deduction	(\$15,000)	(\$15,000)
Additional stock option deduction	<u>NIL</u>	<u>(\$15,000)</u>
Net taxable income	\$15,000	NIL
Tax payable @ 46.4% (b)	\$6,960	NIL
Donation tax credit (c)	\$23,200	\$23,200
<b>Tax savings (c) – (b)</b>	<b>\$16,240</b>	<b>\$23,200</b>
<b>Total cost of donation (a) +(b) – (c)</b>	<b>\$33,760</b>	<b>\$26,800</b>

Based on the above table, the executive has saved \$6,960 [\$33,760 - \$26,800] by donating \$50,000 of stock in the same year and within 30 days of exercise instead of donating \$50,000 of cash. This savings of \$6,960 is due to the tax savings related to the additional 50% stock option deduction

## Cash-less exercises

In some cases, your employer will use a broker to administer the company stock option program. In this case, the broker will sell the stock that is acquired upon exercise, deduct your strike price from the sale proceeds (and possibly even deduct withholding tax) and provide you with the net cash. This is called a “cash-less” exercise.

In this case, if you direct the employer’s broker to donate the net cash to a charity (after they deduct your strike price) **in the same year of exercise and within 30 days after exercise**, then you will be eligible for the normal 50% deduction plus also an additional tax deduction against your stock option benefit. This is the one scenario where you are eligible for the additional stock option deduction even though cash is donated and not shares in-kind. **However, since the broker is not donating cash equal to the fair market of the shares sold (since they deducted your strike price from the sale proceeds before donating) your additional deduction will not be the full 50%.** The amount of the additional deduction on top of the normal 50% deduction if you direct the broker to donate all the net cash upon exercise is based on the following formula:

Stock option benefit x 50% x Net cash donated  
 Fair market value on sale of employer stock before  
 deducting strike price

Let's use the same example as before, however this time the executive does a cash-less exercise and therefore donates only the net difference of \$30,000.

	Cash-less exercise and donate net cash of \$30,000 after 30 days of exercise	Cash-less exercise and direct broker to donate \$30,000 cash in same year and within 30 days of exercise
Value at exercise	\$50,000	\$50,000
Strike price	<u>(\$20,000)</u>	<u>(\$20,000)</u>
Stock option benefit/Net cash donated (a)	\$30,000	\$30,000
Normal 50% stock option deduction	(\$15,000)	(\$15,000)
Additional stock option deduction	<u>NIL</u>	<u>(\$9,000) (*)</u>
Net taxable income	\$15,000	\$6,000
Tax payable @ 46.4% (b)	\$6,960	\$2,784
Donation tax credit (c)	\$13,920	\$13,920
<b>Tax savings (c) – (b)</b>	<b>\$6,960</b>	<b>\$11,136</b>
<b>Total cost of donation (a) +(b) – (c)</b>	<b>\$23,040</b>	<b>\$18,864</b>

(\*)  $\$30,000 \times 50\% \times \$30,000 / \$50,000$

In this case, the executive saves \$4,176 [ $\$23,040 - \$18,864$ ] by directing the broker to donate the \$30,000 net cash in the same year and within 30 days of the cash-less exercise, instead of donating the cash after 30 days of exercise.

If you would like to receive the full additional stock option deduction of 50% (without prorating), then if permitted you may consider not doing a cash-less exercise but rather pay for the exercise cost with other monies and donate the shares in-kind in the same year and within 30 days of exercise. This will allow the full 50% additional stock option deduction on top of the normal 50% deduction for a total stock option deduction of 100%, which will eliminate all the tax on the stock option benefit.

## Stock option calculator

In many cases, you will not want to donate all the stock exercised but rather wish to donate only a portion of the shares exercised and then sell the remaining portion for diversification and/or for lifestyle expenses. As a result, the donation tax credit on the portion of the shares that you donate can reduce the tax liability on the stock option benefit triggered on the portion of the shares that you do not donate. **This begs the question, what portion of my shares do I need to donate within 30 days of exercise so that the tax on the entire stock option exercise and sale is eliminated?** To answer this question, speak to your advisor as they have access to an employee stock option calculator, which can determine the specific number of shares (or net-cash after a cash-less exercise) to donate from the exercise of your stock options to eliminate all tax. An example of the output from this calculator is provided at the end of this article.

This is a great strategy to donate to your favorite charity, keep the majority of the sale proceeds for reinvestment or for your lifestyle expenses and eliminate the entire tax bill on the exercise of your employee stock options.

Furthermore, if you have thought about leaving a legacy but are unclear the best way to do this for yourself and your family, then speak to your advisor about setting up your own charitable foundation. That is, you can take advantage of these new tax rules and leave a legacy by exercising your stock options and then donating the stock or cash proceeds to your own charitable foundation.

## Stock Option Calculator

Assumptions	
Number of options to exercise	1,000 (enter in blue shaded cells only)
Assumed market value at exercise and sale	\$ 50.00
Strike price	\$ 20.00
Cash-less exercise	No (*)
Province of residence	Ontario (**)

(\*) If cash-less exercise then only net-cash (after strike price deducted) is donated by broker. If not a cash-less exercise, then shares acquired are donated in-kind.

(\*\*) Calculations below assume employee is in the top marginal tax bracket in province of residence.

### Option A: Exercise options, sell all shares and retain proceeds

Value at exercise	\$ 50,000
Strike price	\$ (20,000)
Stock option benefit	\$ 30,000 (A)
Stock option deduction	\$ (15,000)
Taxable income	\$ 15,000
<b>Net tax savings/(tax payable)</b>	<b>\$ (6,960) (B)</b>
<b>Increase or (decrease) in net worth</b>	<b>\$ 23,040 (A) - (B)</b>

### Option B: Exercise options and donate all shares (or all net-cash) in same year and within 30 days

Shares donated	\$ 1,000	
Value at exercise	\$ 50,000	(donation amount if not cash-less exercise)
Strike price	\$ (20,000)	(C)
Stock option benefit	\$ 30,000	(donation amount if cash-less exercise)
Stock option deduction	\$ (30,000)	
Taxable income	\$ -	
Tax payable on stock option benefit	\$ -	
Donation tax credit	\$ 23,200	
<b>Net tax savings/(tax payable)</b>	<b>\$ 23,200 (D)</b>	
<b>Increase or (decrease) in net worth</b>	<b>\$ 3,200 (D) - (C)</b>	

### Option C: Exercise options and donate that portion of shares (or net cash) in same year and within 30 days of exercise to eliminate tax

Click here to determine the specific number of shares to donate in same year and within 30 days of exercise to eliminate all tax

<b>Number of shares to donate to eliminate tax</b>	<b>231</b>
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Shares donated	\$ 231
Value at exercise and donation	\$ 11,538
Strike price	\$ (4,615) (E)
Stock option benefit	\$ 6,923
Stock option deduction	\$ (6,923)
Taxable income	\$ -
Tax payable on stock option benefit	\$ -
Donation tax credit	\$ 5,354
Tax savings	\$ 5,354 (F)

Shares retained	\$ 769
Value at exercise	\$ 38,462
Strike price	\$ (15,385)
Stock option benefit	\$ 23,077 (G)
Stock option deduction	\$ (11,538)
Taxable income	\$ 11,538
Tax payable	\$ (5,354) (H)

<b>Net tax savings/(tax payable)</b>	<b>\$ - (F) - (H)</b>
<b>Increase or (decrease) in net worth</b>	<b>\$ 18,462 (G) - (H) - (E) + (F)</b>

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