TD Wealth

Charitable Giving and Employee Stock Options

If charitable giving is part of your overall wealth strategy, you may consider tax-efficient gifting strategies. When you donate to a qualified charitable organization (a qualified donee), you receive a donation receipt for which you can claim a charitable donation tax credit. Your tax credit helps reduce your taxes and in turn, the cost of your donation. When you donate shares received under an employee stock option plan within 30 days of exercising those options and within the same calendar year, you'll receive an additional tax benefit, which helps to reduce the taxes you would otherwise pay on exercising your stock options. Taken together, it is often more tax-efficient to donate shares received under a stock option plan than to donate cash.

Taxation of Employee Stock Options

To help understand the tax benefits, let's first look at how employee stock options are taxed. You are considered to have received an employment benefit when you exercise your stock options. The amount of the employment benefit is generally the difference between the fair market value (FMV) of the shares and the exercise price, less the amount you paid, if any, to acquire the stock options. The stock option benefit must be included in your income and is taxed at your marginal tax rate. However, a deduction might be available to reduce the employment benefit by 50% (the stock option deduction). This results in the employment benefit effectively being taxed like a capital gain.

In general, the following conditions must be met to qualify for the stock option deduction[1]:

- the employer corporation (or a corporation not dealing at arm's length with the employer corporation) is the issuer of the shares;
- the shares are "prescribed shares" (which generally mean ordinary common shares and not preferred shares) at the time of their sale or issue;
- the option exercise price must generally be no less than the FMV of the shares at the time the option is granted; and
- at the time immediately after the stock option agreement was made, the employee deals at arm's length with the employer corporation and, where applicable, with the issuer corporation (who does not deal at arm's length with the employer corporation).

The below example illustrates how stock options are taxed.

FMV at exercise	$100,000
Less: Exercise price	($20,000)
Stock option benefit	$80,000
Less: Stock option deduction (50%)	($40,000)
Taxable Benefit (Income)	$40,000
Tax payable (at a 50% tax rate)	**$20,000**

For more information on taxation of stock options, including how Canadian-controlled private corporations (CCPC) options are taxed, please see our article titled "Taxation of Employee Stock Option Benefits".

Donating Shares Received under a Stock Option Plan (within 30 days and within the same calendar year)

When you donate public company shares received under an employee stock option plan within 30 days of exercise and within the same calendar year, an additional deduction may be available to further reduce the employment benefit included in your income (the stock option donation deduction). The deduction is equal to 50% of the lesser of (i) the employment benefit and (ii) the fair market value of your shares at the time you donate them minus the exercise price. This means the employment benefit will be fully eliminated if the value of your shares does not decrease after you acquire them. Additionally, if the value of your shares increase, the capital gain is exempt from tax.

In general, the following conditions must be satisfied to qualify for the stock option donation deduction[2]:

- The employee must be eligible for the stock option deduction;
- If the security is a share, it must be of a class listed on a prescribed Canadian or foreign stock exchange, such as the TSX or NYSE; and
- The donation must be made to a qualified donee within 30 days and within the year the security is acquired.

When you donate your shares, you will also receive a donation receipt for the fair market value of your shares, which you can use to claim a charitable donation tax credit. This can be used to reduce the tax payable on other taxable income.

Donating Cash Proceeds from a Cashless Exercise

The above approach requires you to purchase the shares for the exercise price. If you do not have cash available to pay the exercise price, it may be possible to do a "cashless exercise". To receive the stock option donation deduction in those circumstances, you must direct the broker or dealer to immediately sell your shares and donate all or a portion of the net proceeds to a qualified charity within 30 days of exercise and within the same calendar year. The amount of your stock option donation deduction will be prorated based on the amount paid to the registered charity.

This approach generally results in a smaller donation because the broker or dealer would pay the exercise price (rather than the FMV) to your employer out of your share sale proceeds. This means your stock option donation deduction and donation tax credit will be less than if you had acquired the shares and donated them.

Example of Different Approaches

The following example illustrates the tax benefits associated with the above approaches. Ethan owns vested employee stock options with an exercise price of $20,000 and fair market value of $100,000. Ethan is considering exercising his stock options and donating the shares or doing a cashless exercise and donating the net proceeds. If Ethan does a cashless exercise, he is also considering donating an additional $20,000 later in the year to bring his total donation up to $100,000. The different outcomes are below.

	Exercise options and donate shares within 30 days and within the same calendar year	Cashless exercise and donate net proceeds within 30 days and within the same calendar year	Cashless exercise, donate net proceeds within 30 days and within the same calendar year and $20,000 cash
FMV at exercise	$100,000	$100,000	$100,000
Less: Exercise price	($20,000)	($20,000)	($20,000)
Stock option benefit	$80,000	$80,000	$80,000
Less: Stock option deduction	($40,000)	($40,000)	($40,000)
Less: Stock option donation deduction	($40,000)	($32,000)[3]	($32,000)
Income Inclusion	Nil	$8,000	$8,000
Tax payable (at a 50% rate) (b)	**Nil**	**$4,000**	**$4,000**
Net donation amount (cash/stock)	$100,000	$80,000	$80,000
Other donation amount	Nil	Nil	$20,000
Total donation (a)	$100,000	$80,000	$100,000
Donation tax credit (at a 50% rate)[4] (c)	$50,000	$40,000	$50,000
Cost of donation strategy (a)+(b)-(c)	**$50,000**	**$44,000**	**$54,000**
Tax savings	**$50,000**	**$36,000**	**$46,000**

Based on the above, the most tax-efficient approach would be for Ethan to exercise his stock options and donate the shares. This approach produces the highest tax savings because it fully eliminates the employment benefit and produces the highest donation tax credit. If Ethan is unable to pay the exercise price, donating the net proceeds from a cashless exercise would also result in a significant tax savings, especially when compared to donating cash.

Multiple Exercises under Stock Option Plan

You may own shares that you previously acquired under your stock option plan. When you own identical shares exercised at different times, for tax purposes they are assumed to be donated in the order you acquired them. This can sometimes pose a problem given that the stock option donation deduction is only available where shares are donated in the year they are acquired and within 30 days of acquiring them.

In the above example, assume Ethan had acquired a similar number of shares in the previous year. When Ethan donates his shares in the current year, he will be considered to have donated the shares he acquired in the previous year. As a result, Ethan would not be entitled to the stock option donation deduction of $40,000 and his tax savings would decrease by $20,000. To avoid that result, Ethan could designate on his tax return that the newly acquired shares were the shares he donated. As long as certain other conditions are met, Ethan will then be entitled to the stock option donation deduction. The designation can also be used to optimize the stock option donation deduction in a cashless exercise of Ethan's stock options and subsequent donation of the net proceeds.

Changes to the Stock Option Rules

Changes to the taxation of stock options first proposed in the Federal Government's 2019 budget received royal assent in June 2021. Under the new rules, the annual limit on employee stock options that may qualify for the 50% deduction is capped at $200,000. The changes apply to stock options granted on or after July 1st, 2021. The limit does not generally apply to stock options granted from Canadian-controlled private corporations (CCPCs) or non-CCPSs with yearly gross revenue of $500 million or less. Moreover, in order to ensure compliance with the new rules, significant additional tracking and notification requirements are imposed on companies.

Considerations

Your TD advisor and your professional tax advisor can assist you in developing a charitable giving strategy utilizing shares acquired by exercising your stock options where appropriate.

Donating shares acquired under a stock option plan is a tax-efficient strategy to fulfill your charitable giving objectives. Not only do you receive the tax advantage associated with a donation tax credit, it is also possible to eliminate the taxes otherwise payable on the stock option benefit and capital gain on your shares.

[1]For employees who reside in Quebec, additional conditions must be satisfied to qualify for the stock option deduction for Quebec provincial tax purposes. If those conditions are not satisfied, employees are instead entitled to a 25% deduction.

[2]For employees who reside in Quebec, if those conditions are satisfied, employees are also entitled to an additional 50% deduction on top of the stock option deduction, which may be 25% or 50%.

[3]$80,000 x 50% x ($80,000/$100,000)

[4]The actual donation tax credit rate varies by province and territory and based on certain other factors.

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