Proper Handling of Stock Options can Provide Significant Tax Savings by using the Private Giving Foundation

Stock options can be an important component of an overall compensation plan. These options are granted by a corporation to certain employees and confer the right to buy a specified number of the corporation's shares at a pre-determined price (the exercise price) during a particular time period.

From the perspective of the granting corporation, stock options may constitute a powerful tool to attract and retain top talent. They are typically granted to senior executives but some companies also offer them to rank-and-file employees. According to Watson Wyatt, a high profile human resource consulting firm, 98.6% of companies in the S&P/TSX Composite Index had stock option plans in place in 2003.

When stock options are exercised, the difference between the stock's fair market value and its exercise price is considered a taxable employment benefit and is taxed at the same rate as a capital gain. This means that 50% of the difference is taxable as income. However, if the stock is donated to a registered Canadian charity within 30 days of the exercise date (provided it is within the same calendar year) the tax is eliminated.

Over many years of working with executives in an advisory capacity, I have been struck by their commitment to charitable giving, not only in terms of their time but also in terms of financial support. However, opportunities to maximize tax benefits by gifting stock – including stock obtained through the exercise of stock options - are often overlooked.

I have also found that it is all too common for an executive's investment portfolio to have a large concentration in a single stock – that of his or her employer. Such a concentration may provide a strong incentive to work hard on behalf of shareholders who, after all, include the executive. Unfortunately, such a lack of diversification entails considerable risk for the executive since much of his or her wealth is tied to the ups and downs of a single company's share price.

However, if the executive is philanthropically-minded, and it appears that many are, stock options can be used to reduce this risk while fulfilling charitable objectives in a tax efficient manner.

Case Study

I recently worked with an executive of XYZ Corporation. He was heavily invested in the stock and stock options of XYZ Corporation. In fact, 90% of his investment portfolio consisted of that one position. He gave generously to several charities each year by writing a series of cheques.

We worked out the following scenario with him:

Step 1 He exercised one set of options and sold the stock he received as a result.

Step 2 With the help of his investment advisor, he invested the proceeds of the sale in a diversified portfolio.

Step 3 We calculated the tax liability generated in Step 1. We used this calculation to determine a target amount of stock that should be donated to a registered Canadian charity to offset the liability.

Step 4 He exercised a second set of options and donated the stock to the Private Giving Foundation, a registered Canadian charity. The Foundation will invest the funds and direct income and capital appreciation to charities recommended by the executive. He may recommend one charity or several and change these each year if he wishes.

Benefits

- ✓ The concentration of XYZ stock in his portfolio was reduced and his overall level of diversification was improved.

- ✓ His donation of shares to the Private Giving Foundation was tax-free. Furthermore, as a result of the donation he received a charitable tax receipt that can be used to offset the tax liability generated in Step 1.

- ✓ The donor-advised fund arrangement will allow him to direct his charity dollars as he sees fit, but without the necessity of writing cheques each year and without the set-up and on-going legal fees, board meetings and administrative burden associated with establishing and maintaining a private foundation.

- ✓ If he wishes, he may attach his name to the fund and even name a successor to direct his charitable dollars and ensure that his philanthropic legacy is carried on by future generations.

Everyone's situation is different, so please consult your tax advisor to determine the most appropriate strategy for your situation.

This article was prepared by, Jo-Anne Ryan, Vice President, Philanthropic Advisory Services, TD Waterhouse Canada Inc. and the Executive Director of the Private Giving Foundation, the first donor-advised fund program to be set up by a financial institution in Canada. www.tdwaterhouse.ca/privategiving

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