

Investment Strategies:

Covered call options and their tax treatment



Frequently investors look to their equity portfolio to help generate income for them by purchasing high yield equities or using other strategies. This is particularly true when coupon rates on fixed income instruments are low. One investment strategy used in flat market conditions involves the selling of call options on equities that are present in the portfolio – a “Covered Call Strategy”. This strategy is well-suited to an environment when a stock trades on a relatively tight price-band, and the investor doesn’t foresee large upside price-potential for the stock. It is normally used with shares held in non-registered accounts, although can be used in RSPs, RIFs and TFSAs. Generally, the shares would be held in the same account as the call option being sold.

Investors who use this strategy are paid a premium for “writing” the call option contract – taking on the obligation to sell the shares at a specified “strike” price. The writer of the covered call option continues to be the owner of the shares and enjoys the rights of ownership such as collecting dividend payments, unless the option is exercised. The risk to the option seller or writer is the risk of being “called away” – being forced to sell the shares at the strike price, leaving the seller with the premium and the proceeds of the sale (less costs). Determining how to price a covered call option contract can be difficult. The investor selling the call option (the option writer) needs to account for volatility of the share price, potential dividends and the timing of the option’s expiry. The general formula used in determining the maximum profit is: The premium received + the strike price of the call option – the investor’s original purchase price of the stock – any applicable commission.

The writer/seller will generally do well when the underlying price of the stock equals or goes higher than the than the strike price. However, the buyer is not obligated to exercise the option to buy. Generally, a call option will be exercised when the price of the share rises above the strike price. The option is then considered to be “in the money”. Both seller and buyer benefit from the sale.

For example, Brian has a portfolio that contains ABC Inc. stock. The book value/cost base of each stock is \$127. But it is currently trading at \$135 per share. Brian writes a covered option for a 100 of his ABC Inc. shares at the strike price of \$138, and a premium of \$1 per share. The option contract has an expiry date of 10 business days.

If the stock price rises to \$142, higher than the \$138 strike price, during the duration of the contract, and the stock is “called away” by the buyer, Brian earns a profit of \$11 per share ($\$127 + \$11 = \138), plus the \$1 premium. If the stock had not reached \$138 by the option expiry date, Brian would only be left with the \$1 premium price and would retain the shares.

Tax treatment of covered call options

The tax treatment of a call option depends on whether the shares are/were held on account as income or capital. For example, an investor who trades the shares regularly or holds the shares for a short time might be seen by the Canada Revenue Agency as holding the shares on account of income.

Let’s look at two scenarios:

Scenario 1: Brian’s 100 ABC Inc. shares remains below the per-share strike price of \$138 until the call option contract expires. Since the option has expired and the buyer has not exercised the option, Brian continues to hold the stock and retain the \$1 per share premium he received for writing the option. He can now write a new call option for those shares with a new expiry date.

Scenario 2: Brian’s ABC Inc. stock price rises above \$138 during the option period. He is obligated to sell the shares at \$138 each. The buyer benefits from the increase above the strike price. Meanwhile, Brian also retains the premium, as well as any dividends the shares earned while the option was unexercised.

Premiums received on call options written on account of income are generally included in income when the option expires or exercised. Premiums received on call options written on account of capital result in an immediate capital gain. However, the capital gain is generally reversed if the option is exercised (as opposed to expired), and included as part of the proceeds of the disposition of the shares.

Therefore for Scenario 1, assuming that the underlying shares were being held on account of capital, the \$100 premium would generally constitute a capital gain at the time it was received. For Scenario 2, assuming that the underlying shares were being held on account of capital, the premium would generally be added to the proceeds from the sale of the shares for the purposes of determining the capital gain on the sale.

Please note, when a call option merely reaches the strike price, the buyer may not exercise the option. Therefore, either Scenario 1 or 2 may result.



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