A Choice of Options

Summary

What are they? Who has them? What do you do with them? How are they taxed? These and other questions will be answered in plain English, giving tax professionals a better understanding of the investment world. Topics will include puts, calls, rights, warrants, futures, forwards, foreign currency transactions, employee stock options, incentive stock options, as well as the trading methodologies and tax treatments of each—basis, income recognition under IRC §83(b), and (of course!) AMT.

The information contained herein is for educational use only and should not be construed as tax, financial, or legal advice. Each individual's situation is unique and may require specialized treatment. It is, therefore, imperative that you consult with tax and legal professionals prior to implementation of any strategies discussed.

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op·tion [op-shuh n][1]
noun
1. the power or right of choosing.
2. something that may be or is chosen; choice.
3. the act of choosing.

I. Introduction

An option is a choice to do something—whether you state your preference, make a selection, come to a decision, or simply elect to "keep your options open"; you are presented with the opportunity to evaluate alternatives. Even "[i]f you choose not to decide, you still have made a choice."[2] In some unfortunate circumstances you may find yourself faced with an "option of last resort" or discover that you are "out of options".

Since "failure is not an option", I will do my best to help you to understand options in the general sense, as well as options specific to the investment world, including calls, puts, rights, warrants, futures, restricted stock, and mineral rights. Once these options have been defined, I'll discuss the tax treatments of each.

II. Definitions

A. Terms

Let's start off with grocery store coupons; the kind that you clip out of the Sunday paper. Maybe it's a corn flakes coupon that offers a 50¢ discount next time you shop for cereal.

What makes this an option? This corn flakes coupon gives you a choice. If you have a choice, you have an **option**. Actually, you have several choices: You have the *choice* to go shopping, use your coupon and save money on cereal. Of course, if you don't need or want cereal, you have the *choice* to leave the coupon at home or even buy a different brand of cereal and ultimately not use your coupon.

Options of this sort always require two players: In this case, we have you (the coupon clipper and cereal shopper) and the issuer (the cereal manufacturing company that printed the coupon and is now offering the discount) – let's call them Kellogg's to keep things simple. As the coupon clipper, you are known as the **holder** since you quite obviously are in possession of the coupon and are holding it. Kellogg's is known as the **writer** since it created the coupon and allowed it to be printed in the paper.

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[1] option. (n.d.). *The Free On-line Dictionary of Computing*. Dictionary.com [available at http://dictionary.reference.com/browse/option, last accessed January 13, 2012].

[2] "Freewill", Lyrics by RUSH [available at http://www.azlyrics.com/lyrics/rush/freewill.html, last accessed January 13, 2012].

Notice that in this scenario, you as the cereal shopper have choices but that Kellogg's as the issuer has none. If you choose to go shopping and buy cereal, Kellogg's *must* honor the coupon and sell the cereal to you at a discount. Kellogg's does not have the option to walk away from the deal. So, options will always involve two parties – one party will always have a choice; the other will always have an obligation.

Coupons – and by extension options – also have another feature: They have an **expiration date**. In the case of the cereal coupon, you have to make your decision to buy cereal before the deadline, usually written in microscopic fine print. If, by chance, you do not make your decision in a timely manner, the coupon becomes null and void and the only choice left to you is to wad up the coupon and toss it in the trash. A bit of a waste since you spent $1.25 on the newspaper and, assuming that you had no interest in news and that your only reason for buying the paper was to clip coupons, you've now lost your investment in its entirety.

B. Types of Options

Following the example of a corn flakes coupon, I can now introduce you to various types of options in the investment world. Keep in mind that in all cases, two parties are involved and that one party will always have the right to choose a course of action which often entails the purchase (or sale) of an **underlying security**. In my original scenario, the underlying security was a box of corn flakes; henceforth underlying securities may be shares of a single stock or an entire index, a bond, a commodity, a foreign currency, or other financial instrument.

For example, a stock option gives one party the right (choice) to buy shares of stock at a designated price, while the contra-party is then required (obligated) to sell those shares. In an attempt to standardize option trading in the investment world, option contracts are established using specified amounts of underlying securities. Here, with a regulated stock option, the set amount is always 100 shares; thus, one party may buy 100 shares of a specific stock by exercising his option prior to the expiration date and the other party must sell 100 shares at the pre-established price.

The option that I have just described is a **call** option; wherein the purchaser of the option (the holder) has the choice to buy 100 shares of, let's say IBM stock, and the seller of the option (the writer) is required to sell 100 shares of IBM in the event that the option is exercised. Note that the holder is in the driver's seat – it is he who has the choices and can dictate the destiny of the IBM stock. He can exercise his option and buy the stock or he can choose to let the option expire and forego the stock. The writer is simply along for the ride and must wait for the holder to make his decision. In fact, the holder of an option is, by definition, the decision-maker.

However, the parties to a transaction can flip roles. In our first example, the cereal shopper was the holder and had a choice to buy cereal (or not); Kellogg's

was required to sell its cereal at the shopper's discretion. What if we wanted to take the choice away from the shopper and instead give it to Kellogg's which could now choose to sell its cereal at a designated price and force the shopper to buy it? Were that the case, we would have just created a **put** option.

In the investment world, puts allow the holder of the option the choice to sell 100 shares of IBM to the writer of the option who must then buy the stock at the designated price. Puts and calls are identical in all respects: Both are options that give the holder a choice and the writer an obligation; both can be used to determine the fate of 100 shares of IBM which may be bought or sold; both expire at a specific time. The only distinction is who is the holder (with the choice) and who is the writer (with the obligation).

Allow me to introduce another example to help clarify: You've just purchased a brand-new BMW and after spending an hour haggling with the car salesman, you're about to close the deal when he asks you if you would like to purchase the extended warranty. Tired and worn-out, you quickly agree.

Once again, we have an option: You, the car buyer now have a choice to have your car repaired at any time before the warranty expires in three years. On the other hand, the car dealer is now obligated to fix your car if ever you should choose to bring it in for repair. In effect, you are the holder of a call option and may *call* upon the writer of the option at your whim.

Now let's switch roles; but be careful which roles we are switching! You are still a car buyer, the one with bundles of cash in your pocket. BMW is still the car dealer with an inventory to sell and a repair shop. Those roles do not change. However, let's switch who gets the choice and who gets the obligation and create a put. While unlikely in the real world, bear with me here: Assume that you create an option which gives the car dealer the right to force you to come in to his shop and have your car repaired – he now has the choice and, however silly it sounds, you now have an obligation. The roles we have switched are those of holder and writer; we have not changed our inherent natures (that of car buyer and car dealer), but we have changed who has a choice and who has an obligation.

C. Let's Talk Money

Options are not free. Even our corn flakes coupon cost $1.25 since it could only be obtained by buying the Sunday paper (which you claimed to have no use for other than the coupon section). Thus, the price that you paid for the paper effectively is the price you paid for the coupon. We refer to that price as the **premium**.

Premiums in the investment world are, for the most part, determined by supply and demand. Since there is only a limited supply of regulated stock options, the cost of these options will increase if many people wish to purchase them and the price will drop if few people want to buy them. Similarly, try selling umbrellas to soaking wet pedestrians on a rainy day versus bikini-clad sunbathers on a sunny day.

But the premium is also dependent on another factor. Say, the stock option gives you the right to buy 100 shares of IBM for $185/share (**strike price**). You check the current market price of the stock and discover that IBM is trading for $180. Of course, there would be no need to use your option to buy the stock since you could buy it for less without the option.

But let's say the option is good for another six months and the price of IBM rises steadily during that time. And at some point the market price of IBM is higher than the strike price, making it very attractive to use the option to buy the stock at a bargain price (there is **intrinsic value**). Now the option has value – it's a coupon that offers you a bargain. You'll want to buy it, as will many other investors.

But time marches on inexorably and eventually runs out. What if, during that time, the market price of the underlying security (IBM) does not change or even begins to drop? The option becomes less and less attractive as you sadly realize that the price of IBM may never exceed the strike price before the expiration date. And remember, that any price increases after the expiration date are irrelevant to you because the option has already become useless (worthless).

Thus, simply due to the passage of time, option premiums will decrease with time and ultimately have no value; much like the corn flakes coupon that had to be tossed if it remained unused by the time the expiration date rolled in. To summarize, the option premium is based on the option's intrinsic and time values.

Terms Defined

Option	a choice to buy or a sell a security
Underlying Security	the financial instrument on which the bet is placed
Holder	the purchaser of the option (said to "long the position") who may choose to buy (or sell) the underlying security
Writer	the seller of the option (said to be "short the position") who is obligated to sell (or buy) the underlying security
Call	the holder of a call has the right to *buy* the underlying security the writer of a call has the obligation to *sell* the underlying security
Put	the holder of a put has the right to *sell* the underlying security the writer of a put has the obligation to *buy* the underlying security
Premium	the price of the option (consists of Intrinsic Value + Time Value)
Strike Price	the pre-determined price at which the underlying security may be bought (or sold)
Expiration Date	the date on which the game is up!

III. Regulated Stock Options

These options are standardized contracts created by the Options Clearing Corporation (OCC)[3] which not only establishes the trading ground rules but also approves which financial instruments may be selected by the exchanges to serve as underlying securities, including equities (stocks), indexes, debt securities (bonds) and foreign currencies. While the OCC employs various criteria, the primary factor influencing selection is popularity (evidenced by high trading volume), volatility and market capitalization.[4] Much like gamblers in Vegas are offered odds on horse races and football games because there is sufficient interest, they are not offered the opportunity to bet on extreme ironing or buzkashi.[5] So while there are many thousands of stocks available for trade, only several hundred of these equities serve as underlying securities for options trading.

As we have already learned, the holder of a call option hopes that the market will rise. If it does, he can exercise his option to buy the underlying stock at a previously fixed price which is presumably less than what he would have otherwise had to pay on the open market. Thus, this is a bullish strategy. On the other hand, the holder of a put hopes that the market will decline. If it does, he can exercise his option to sell the underlying stock at a previously fixed price which is presumably more than what he could otherwise have gotten on the open market. Thus, this is a bearish strategy.

The holder, however, need not exercise. He may instead allow his option to expire; thereby forfeiting the premium paid. Or, he may choose to **close out** or sell (eliminate) his position, hoping to profit from the difference between the premium received on sale and the premium paid when he bought the contract.

A. Tax Consequences[6]

Options are considered to be capital assets and, therefore, all transactions involving the purchase, sale or expiration of options are deemed to be capital transactions reportable on Schedule D. Because regulated stock options have a

[3] Founded in 1973, the OCC is "dedicated to promoting stability and financial integrity in the marketplaces." The OCC acts as guarantor, ensuring that the obligations of the contracts it clears are fulfilled. [OCC's mission statement, available at http://www.theocc.com/about/, last accessed January 14, 2012].

[4] Mayhew & Mihov, *How Do Exchanges Select Stocks for Option Listing?,* The **Journal of Finance**, Vol. 59, Issue 1, pp. 447 – 471, February 2004.

[5] According to the Extreme Ironing Bureau, [extreme ironing] is "the latest danger sport that combines the thrills of an extreme outdoor activity with the satisfaction of a well-pressed shirt." Originating in England it is now a worldwide phenomenon that has taken place underwater, on mountainsides, and while parachuting. In contrast, the goal of Buzkashi is simple – grab the carcass of a headless goat at full gallop, get it clear of the other players, and pitch it across the goal line. Played all over South Central Asia, it is the national sport of Afghanistan. [*The 25 Most Obscure Sports in The World*, posted by David Pegg, available at http://list25.com/the-25-most-obscure-sports-in-the-world/, last accessed January 14, 2012].

[6] IRC § 1234.

maximum duration of 9 months – all expire on the third Saturday of the expiration month – all transactions relating to the disposition of these options are categorized as short-term since none can exceed the one-year holding period required for favorable long-term tax treatment. NOTE: Long-term Equity Anticipation Securities (LEAPS), introduced in recent years, expire within two to five years; LEAPs, therefore, can generate long-term capital gains.

1. Tax Consequences for the Holder (buyer of the option)

To begin, the holder of an option – whether call or put – was required to pay for the option and has spent the premium plus any commissions his broker may have charged him. This total, then, represents the holder's cost basis. If no further transactions transpire and the option becomes worthless at expiration, the holder will forfeit his entire investment and suffer a short-term capital loss equal to his cost basis [long-term in the event of a LEAP held for more than one year].

However, you may recall that the holder has several choices which he may employ at any time prior to the option's expiration date. If, for example, the holder elects to use (exercise) his call option to purchase the underlying security, the cost basis of the option is simply added to the cost of the security purchased at the strike price. The taxpayer's holding period for the stock begins on the day after the option is exercised.

Example

On January 13, 2012 when the price of Yahoo stock is $15.48/share, Bob buys a JUL 14 Call on Yahoo for $2.52. Translated into English, Bob has just spent $252 (plus commissions; let's assume $50) on an option contract that allows him to buy 100 shares of Yahoo stock for $14/share any time between now and the expiration date on July 20th, 2012.[7]

This option is currently in-the-money; in other words, if Bob were to exercise the option, he would be able to purchase Yahoo stock for a savings of $1.48/share (= Market Price – Strike Price). If Bob did in fact exercise his option, he would have no immediate taxable event but would instead add the cost of his option ($252 premium + $50 commission) to the cost of the newly purchased stock ($1400 strike price) for a total cost of $1702 (his basis). Should he later sell the stock, he would use this basis to determine his realized gain or loss.

Rather than exercise, the holder may decide to close or rid himself of the position by selling the option – not the underlying stock – to another investor at a price determined by prevailing market conditions. Now the taxpayer must recognize a capital gain or loss equal to the difference

[7] Standardized nomenclature ensures that all investors know to multiply premiums and strike prices by the standardized contract size of 100 shares and July 20th happens to be the 3rd Saturday of the stated expiration month. This means, that the option was originally created nine months before its expiration and was first traded in October 2011.

between his selling and purchase price of the option (net of commissions).

Example

On April 10th, 2012, Bob sells his JUL 14 Call on Yahoo for $0.96 when Yahoo stock is trading for $13.50/share to another investor who remains optimistic that Yahoo may yet climb above $14/share in the remaining months before expiration. Bob must now recognize a capital loss of $256, computed as follows:

	Sales Price $96 – Commissions $50	*$46*
–	*Purchase Price $252 + Commissions $50*	*302*
=	*Realized Loss*	*$256*

To summarize, the holder of a call option will be subject to the following tax treatments:

Action Taken	Tax Consequence
Expiration	STCL (= premium + commissions paid)
Exercise	No gain or loss until disposition of *stock* Basis of stock = strike price + option premium paid
Close Out	STCG if net premium received > net premium paid STCL if net premium received < net premium paid

As can be seen from the chart above, option transactions are not taxed until such time as the position is closed, exercised, or allowed to expire. If those transactions occur after the end of the taxpayer's taxable year, income recognition is deferred. Congress is currently weighing alternatives and may introduce legislation that would "tax derivatives across the board on a current basis as opposed to when the contract is liquidated at a later date."[8]

2. Tax Consequences for the Writer (seller of the option)

The premium a holder pays for an option – whether call or put – goes to the writer (less any commissions the writer may owe to his broker to effect the transaction). Although it may seem logical to report the premium as taxable income, the writer does not actually have a taxable consequence since it is, as yet, unknown whether he will realize a gain or loss. Keep in mind, with the exception of closing out his position (ridding himself of the option by unloading it onto another investor), the writer

[8] *House Ways And Means Staff Weigh Tax Changes for Derivatives*, Martin Vaughan, Dow Jones Newswires [available at http://news.alibaba.com/article/detail/americas/100021696-1-house-ways-means-staff-weigh.html, last accessed February 1, 2012].

remains at the mercy of the holder's decision to exercise or allow the option to expire. Until the holder makes that decision, the writer cannot know his tax consequences.

However, the expiration of an option is deemed to be a capital event, resulting in the recognition of a short-term capital gain equal to the premium the writer originally received. Similarly, if the option position is closed out, the writer must recognize a gain or loss based on the difference between the net premium originally received and the net premium later paid to eliminate the position.[9]

Finally, if the holder of a call option elects to exercise and forces the writer to deliver the underlying security, the writer will receive sales proceeds equal to the strike price of the stock he just delivered. The writer must now recognize a short- or long-term gain or loss, depending upon how long he held the underlying security and the cost basis of his shares (adjusted for the option premium he previously received).

Example

On January 13, 2012, Charlie sold the JUL 14 Call on Yahoo to Bob – the contra-party to the transaction – and received $252 (less a $50 broker's commission). Charlie does not yet have a reportable event.

However, if Bob chooses to exercise the call, Charlie will be required to deliver 100 shares of Yahoo stock to Bob and will receive payment from Bob totaling $1400. Assuming that Charlie originally purchased 100 shares of Yahoo on September 30, 2011 for $13.17/share precisely in the event he would be called upon to ***cover*** *his option position, Charlie would realize:*

	Sales Price of Stock	*$1400*
–	*Cost of Stock $1317 + Commissions $50*	*1367*
=	*Realized Gain*	*$33*

Of course, you might wonder why Charlie would go to such lengths to make a profit of only $33. It would certainly appear to be pointless unless Charlie had previously managed to purchase the 100 shares of underlying stock for less than $13.50/share.

In fact, imagine that Charlie owned Yahoo all along – purchased for just about a dollar per share when the stock was first issued in 1996. In the interim, Charlie watched his investment increase to well over $100/share in late 1999, drop precipitously during the next two years and ride a mild roller coaster between $12 and $40/share ever since. Charlie is content

[9] To close or eliminate an option position, the investor must make a transaction that is opposite of the one that originally established his position. Thus, the holder of an option – who originally purchased the option and now wants to rid himself of it – must later sell that option to remove the investment from his portfolio. On the other hand, the writer of an option – who originally sold the position and took in cash – must now buy back the position and spend cash to remove the investment from his portfolio. REMEMBER: Holders *sell* and Writers *buy* to close out their option positions.

to hold the stock since he believes in its long-term growth prospects, but is disappointed that Yahoo has not paid out any dividends in all these years. Charlie's broker suggested that he could generate an income stream by writing covered calls, whereby he earns the premium on call options he sells to Bob and others. If the market price of Yahoo remains below the selected strike price, the calls will remain unexercised; Charlie may keep his premium and his stock and can repeat the process again by writing another covered call. If the market price exceeds the strike price, Bob will almost assuredly exercise the option and Charlie will have to deliver (sell) his stock. But remember, he bought that stock long ago for next to nothing and now realizes a significant gain as well as the premium he collected when he wrote the option.

In some instances, writers may choose to remain **uncovered** – a far riskier endeavor since they will be called upon to deliver stock they do not yet own. Uncovered writers will be required to purchase shares at the prevailing market price should the call be exercised. Since the holder will only choose to exercise when the market price exceeds the strike price – and there's no telling just how high that market price might be at that time(!) – the writer faces unlimited exposure.

To summarize, the writer of a call option will be subject to the following tax treatments:

Action Taken	Tax Consequence
Expiration	STCG (= premium - commissions received)
Exercise	ST or LTCG if Strike Price > Basis of *stock* ST or LTCL if Strike Price < Basis of *stock* Basis of stock = Cost of stock - net premium received
Close Out	STCG if net premium received > net premium paid STCL if net premium received < net premium paid

We have, so far, discussed the tax consequences of call options but not put options. Where calls give the holder the choice to buy and the writer an obligation to sell the underlying security, puts do the opposite in that they give the holder the choice to sell and the writer the obligation to buy the underlying security. While it's easy to offer real-world examples of calls (corn flakes coupons and car warranties), it's difficult to come up with practical comparisons of puts since it almost seems counter-intuitive to force someone to buy something at the whim of the put holder. Nevertheless, it is so!

As a result, I often suggest that students stick with the easier concept – that of a call – and simply accept that puts are the opposite of calls. Once you grasp the concept of calls, just flip that concept upside-down and now you "understand" puts. I offer a complete summary of tax consequences below and ask you to note that the tax consequences for holders at

expiration or closing are the same, regardless of whether calls or puts are involved. It is only upon exercise, that the tax consequences differ.

	Expiration	Exercise	Close Out
Call Holder [*may* buy stock]	STCL (= prem. in)	ST or LTCG after disposition of stock Basis of stock = strike + prem. out	ST or LTCG (= prem. in – prem. out)
Put Holder [*may* sell stock]	STCL (= prem. out)	ST or LTCG (= strike – basis) Basis of stock = cost + prem. out	ST or LTCG (= prem. in – prem. out)
Call Writer [*must* sell stock]	STCG (= prem. out)	ST or LTCG (= strike – basis) Basis of stock = cost – prem. in	ST or LTCG (= prem. in – prem. out)
Put Writer [*must* buy stock]	STCG (= prem. in)	ST or LTCG after disposition of stock Basis of stock = strike – prem. in	ST or LTCG (= prem. in – prem. out)

B. Holding Periods

As discussed previously, holding periods for option positions, whether expired or closed, are determined by the amount of time the positions remained open. Since regulated stock options most frequently have a maximum duration of only nine months, both holders and writers generally realize short-term gains and losses with holding periods that begin when the positions are opened and end when the options become worthless at expiration or the positions are eliminated in closing transactions.

If, however, the positions are exercised, holding periods are attached to the underlying securities rather than to the options themselves.[10] The applicable rules are designed to "enforce the government's philosophy of allowing long-term treatment of gains only where the [options trader] was at substantial economic risk in the underlying stock during the entire holding period."[11]

To further complicate matters, writers of covered calls – investors who have sold a call option and hold the underlying stock – must establish if their options are in-the-money, at-the-money or out-of-the-money and only then can determine the holding period of the stock. A simple comparison between the strike price of the option and the market price of the stock is used to determine whether potential exercise of the option would be favorable for the holder. Thus, if the strike price is less than the

[10] IRC § 1223.

[11] Brasher, John, *Tax Rules on Stocks and Stock Options*, Reprinted from CallWriter's MONEY newsletter, June 17, 2003 [available at http://www.callwriter.com/newsletter/stock-option-tax-rules.htm, last accessed January 20, 2012].

market price, the holder could exercise his option to call the stock away from the writer and purchase the stock at a bargain, ultimately putting money *in* his pocket. Conversely, if the strike price is greater than the market price, the transaction would be unfavorable for the holder and he would have to shell *out* money from his pocket. And if the strike and market prices were equal, the holder would find neither benefit nor detriment to exercise; the option is said to be at-the-money. [This determination is *always* performed from the perspective of the holder since he is the transaction participant who must determine whether exercise would in fact be favorable or not.]

Stock holding periods are irrelevant for at-the-money and out-of-the-money calls since neither would be exercised. However, options with **intrinsic value** must next be separated into qualified[12] and non-qualified categories to determine if the holding period of the underlying stock is suspended and restarted at the end of the option's life [qualified] or eliminated, reset to zero, and restarted once the option expires or is closed [non-qualified].

C. Wash Sale Rule[13]

This rule was established to prevent investors from making illusionary sales for the purpose of converting paper losses into recognized losses on the tax return. The rule states that an investor, who sells a security at a loss, may not repurchase substantially the same security within 30 days before and 30 days after the date of the sale.

> *Example*
>
> *On June 30, 2011 the investor bought 100 shares of XYZ for $4,000. On August 4, 2011 he sells the shares for $3,300 but repurchases another 100 shares of XYZ for $3,900 the next day. Although the investor realized a loss on the sale of $700, he may not deduct it since he repurchased the same security before the expiration of the window. Instead, he must add the non-deductible loss to the cost basis of the new shares ($4,600 = $3,900 + $700).*

Clearly, the taxpayer had hoped to deduct the loss on his return which otherwise would have remained unrealized.[14] By repurchasing the same security, he had hoped to retain his position and benefit from future appreciation of the stock. The government cannot prevent an investor from buying and selling,

[12] Qualified in-the-money options are those which are exchange-traded, written on stock already owned by the call writer, have more than 30 days remaining until expiration, and have a strike price only minimally less than the security's market price. If "the option has 31-90 days remaining until expiration, it can't be written more than 1 strike point below yesterday's close. But if the call has more than 90 days remaining, you can go 2 strikes below yesterday's close. However, if the stock is $150 or less, you can't write more than $10 in the money no matter what." [Brasher, John, *Tax Rules on Stocks and Stock Options*].

[13] IRC § 1091.

[14] Wash Sale transactions are reported on Schedule D in the normal manner, but a second line entry will be required to remove the disallowed loss by entering it as a positive number as an offset to the loss claimed on the line above.

but this rule is designed to discourage sales if done only to recognize losses rather than for viable financial reasons. Taxes should never be the sole or even the primary motivation for making investment decisions.

On the other hand, if the investor had waited until September 5, 2011 to repurchase the stock, his loss would have been deductible. It is assumed that if someone were to sell a security and then willingly wait for at least a month to repurchase it, he would be exposed to market fluctuations just like any other investor. If he were willing to take that kind of risk, the wash sale rule will not prevent his actions.

Some taxpayers try to circumvent the rule by purchasing other securities. For example, the investor may hope to sell XYZ common stock and replace it with XYZ preferred stock. Sadly, this will not "fool" the tax authorities as the rule clearly stipulates *substantially the same* securities. Thus, the following transactions would all fail under the rule: (a) XYZ common stock for XYZ call option; (b) XYZ preferred stock for XYZ convertible bond; (c) XYZ bearer bond for XYZ registered bond.

Typically, if the securities are issued by the same corporation, they will likely be deemed as being substantially the same. Buying a deep in-the-money call on an underlying security sold within the previous 30 days would fall under the category of "substantially the same" since the holder could readily exercise his option at any time to replace his shares of stock, but the writer of this same call would not be subject to the wash sale rule since the sale of this option does not serve to reinstate his stock holding.

IV. §1256 Contracts

Regulated futures, non-equity options and foreign currency contracts are known as §1256 contracts. Frequently, §1256 transactions remain open at year-end; in other words, the contract has not yet expired or been exercised. However, mark-to-market rules require that the investor treat these contracts as if they had been sold at their Fair Market Value (FMV) on the last day of the tax year. 60% of the computed gain is then treated as long-term while the remaining 40% is treated as short-term on Form 6781, Gains and Losses from Section 1256 Contracts and Straddles.[15]

[15] Senator Carl Levin (D-MI), Chairman of the Senate Permanent Subcommittee on Investigations recently introduced Closing the Derivatives Blended Rate Loophole Act that would revise IRC § 1256 to eliminate "a tax loophole that allows traders in complex derivatives to buy and sell these instruments in days or even seconds, yet claim a large portion of the resulting income as a long-term capital gain." Levin Introduces Legislation to End Tax Loophole that Subsidizes Short-term Speculation in Derivatives, January 23, 2012 [available at http://levin.senate.gov/newsroom/press/release/levin-introduces-legislation-to-end-tax-loophole-that-subsidizes-short-term-speculation-in-derivatives, last accessed February 1, 2012].

A. Futures

A futures contract, also known as a forward contract, is very much like a regulated stock option in that it gives the holder the right to purchase an item at a specified price at a specified time in the future. However, there are some significant differences:

- Futures, unlike options, involve commodities such as oil, metals, grains, and livestock. Financial futures are now available as well.
- Futures trade using the open outcry system on a commodities exchange.[16]
- But most importantly, futures must be exercised upon expiration and require the physical delivery of the underlying commodity as opposed to options which can expire unexercised. Thus, the holder of a pork belly contract better have a BIG freezer when 40,000 pounds of bacon are delivered to him on the expiration date!

A recently introduced investment, known as a securities futures contract, allows the investor to enter into a contract to buy or sell a single security or a narrow-based index in the future. As this is very similar to an equity option, it is treated in the same manner and is therefore not considered a §1256 contract.

B. Foreign Currency Transactions

The IRS distinguishes between two types of currency transactions—those that are regulated (governed by IRC § 1256) and those that are not regulated (governed by IRC § 988), depending upon the market in which the currencies are traded.

1. Non-Regulated Transactions

These transactions, known as cash forex, include all trades which take place in the interbank market[17] as well currency futures traded on a regulated commodities exchange. Resulting gains and losses are treated as ordinary income and taxed at the taxpayer's marginal tax bracket, although losses are not limited by the $3,000 capital loss rule.[18]

NOTE: Because interbank markets are not regulated, taxpayers' transactions will not be reported to the IRS on Forms 1099. Nevertheless, these trades are taxable and should be reported on Form 1040, Line 21 by investors and on Form 4797 by traders.

[16] In August 2007, the Chicago Mercantile Exchange (CME) announced its decision to close the pork belly trading pit by May 2008 as part of its consolidation with the Chicago Board of Trade (CBOT). Pork bellies continue to trade electronically.

[17] The interbank market is used by banks and financial institutions, excluding retail investors and smaller trading parties, to trade foreign currencies.

[18] Wash Sale and Mark-to-Market Rules also do not apply to §988 transactions.

Under certain conditions,[19] a taxpayer may elect out of §988 treatment, thereby converting his ordinary gains to §1256 capital gains. The election does not apply globally, but rather on a trade-by-trade basis and is best made when the transaction has resulted in a taxable gain (since loss treatment is more favorable under §988).

2. Regulated Transactions

These transactions take place on a regulated exchange (not including currency futures) and are treated as capital rather than ordinary income. Regardless of the taxpayer's actual holding period, 60% of the resulting gains are treated as long-term capital gains ("LTCGs"); the remaining 40% are taxed as short-term capital gains ("STCGs").

These trades will be reported to the IRS on Forms 1099 and must be reported by the taxpayer on Form 6781.

V. Employee Stock Option Plans (ESOPs)

Often, a corporation gives its employees the right to buy shares of the employing company in an attempt to motivate employees or provide for compensation that does not directly affect the bottom line of the employer in the current year. Although these options give holders (in this case, the company employees) the right to purchase shares of stock, they are not regulated nor standardized contracts and are treated differently than regulated stock options.

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are currently seeking to establish globally accepted standards mandating that companies treat stock options as an expense in the year granted. A rule requiring public companies to expense options was adopted in 2004 – it became effective June 15, 2005 and should help to decrease over-inflated financial statements. However, Congress continues to weigh proposed legislation that would disrupt the FASB's efforts to harmonize global accounting standards by requiring that only the stock options given to a company's top five executives be expensed. No definitive regulatory guidelines have yet been issued.

A. Types of ESOPs

1. Statutory

These options are granted under a plan which meets certain requirements within the Internal Revenue Code (IRC). Again, two variants exist:

[19] The election can be made for transactions involving a forward or futures contract, or currency options which are capital assets in the hands of the taxpayer and are not part of a straddle (a position in which the investor holds both a call and put with the same strike price and expiration date).

- Incentive Stock Options (ISOs) are often granted on a discriminatory basis to key employees and must be exercised with 10 years after the grant date.
- Employee Stock Purchase Plans (ESPPs) must be nondiscriminatory and are usually offered to non-management employees. They must be exercised within 5 years after the grant date if the price of the option is at least 85% of the FMV of the stock at the time of exercise. Otherwise, the option must be exercised within 27 months of the grant date.

2. Non-statutory

These options do not meet the criteria of the IRC.

B. Tax Treatment

1. ISOs (§421)

Recognition of Income
No income is recognized on the grant or exercise dates, only upon ultimate disposition of the stock. However, if the option is not exercised in the same year it was granted, the difference between the FMV of the stock and the Option Price will be considered a tax preference item for AMT purposes. This information will be provided on Form W-2, Box 14.

Treatment if Exercised
If the option is exercised and the stock is then held for at least one year past the exercise date and two years past the grant date, the eventual gain or loss will be considered long-term[20]. Otherwise, there will be a Disqualifying Disposition and the resulting gain will be included as compensation on Form W-2, Box 1. The basis of the stock is then increased by the amount of compensation recognized.

Example # 1: Holding requirement not met

On February 15, 2009 XYZ granted an ISO option to buy 100 shares at $10/share. Employee exercised the option on October 1, 2011 when the FMV of the stock was $15/share. Employee then sold the stock immediately for $16/share.

*The long-term holding period requirements were not met since the **stock** was not held long enough and so $500 (= $1,500 - $1,000) was included on Form W-2, Box 1 in 2011. A Form 1099-B was issued showing sales proceeds of the stock as $1,600. The adjusted basis was $1,500 (= $1,000 + $500 compensation recognized) and so the resulting gain of $100 was reported as a STCG.*

[20] IRC § 422.

Example # 2: Holding requirement met

If the employee had instead met the long-term holding requirements, no compensation would have been recognized and the entire $600 (= $1,600 - $1,000) would have been LTCG.

Example # 3: Stock sold at loss

Alternatively, if the stock had been sold at a loss, no compensation would have been recognized and the employee would have reported a STCL.

The AMT reportable amount is also added to the stock's basis for AMT purposes, which will result in a smaller AMT gain than regular tax gain in the year of eventual sale. In theory, the AMT paid in the year of exercise creates a minimum tax credit that can be used to reduce the regular tax liability when the stock is sold. But the taxpayer suffers significant tax consequences if the stock price *falls* in the interim.

Example[21]

Taxpayer received ISOs to buy his employer's stock and exercised his options from 1998 – 2000, buying stock worth about $4.5 million for only $128,000. Of course, he paid over $1 million of AMT in 2000 alone!

Then, in 2001, the taxpayer sold his stock for $1.7 million, realizing a significant economic gain (= $1.7 million – 128,000). Unfortunately, however, the stock sale generated a tax loss for AMT purposes (= $1.7 million – 4.5 million).

The taxpayer attempted to subtract the difference between his regular and AMT basis from his AMT calculation in 2001 so that he would have an AMT net operating loss that he could then carry-back to reduce his prior AMT tax liabilities.[22] *But the court held that there was no regulatory authority for this negative adjustment in the year of the stock's sale; instead, only the positive basis adjustment [mentioned above] was allowed. Therefore, instead of an AMT NOL carry-back, the taxpayer was faced with a very large AMT basis that then created a huge AMT loss. And that loss—because stock was considered to be a capital asset—was limited to the $3,000/year limitation on capital losses!*

Beginning in 2007 (through 2012), the Minimum Tax Credit becomes partly refundable, which will allow taxpayers with tax credits due to AMT tax paid more than 3 years ago, to obtain some relief. For taxpayers with an AMT liability resulting from transactions that occurred before the Minimum Tax Credit became refundable, a "Bail-out Bill" has come to the rescue. This legislation abates any underpayment of outstanding tax on

[21] *Marcus*, 129 TC 4.

[22] The taxpayer based his argument on IRC § 56(d)(1)(B) that says that the AMT NOL calculation starts with regular tax income, adjusted for AMT deductions and preference items.

October 3, 2008 attributable to an AMT adjustment for ISOs in any tax year prior to 2008 (including penalties and interest).[23]

2. ESPPs

Recognition of Income

No income is recognized on the grant or exercise dates, only upon ultimate disposition of the stock. No AMT adjustments are required.

Treatment if Exercised

If the option is exercised and the stock is then held for at least one year past the exercise date *and* two years past the grant date, any gain will be considered long-term.[24] Losses occurring when the stock disposition price is less than option price are reported as LTCL and no compensation will be recognized.

Example # 1: Holding requirement met

On February 15, 2009 XYZ granted an ESPP option to buy 100 shares at $10/share when the FMV was $12/share. Employee exercised the option on October 1, 2011 when the FMV of the stock was $15/share. The employee then sold the stock immediately for $16/share.

The long-term holding period requirements were met and so $200 (= $1,200 - $1,000) is reported as ordinary income and $400 (= $1,600 - $1,200) as LTCG.

Example # 2: Stock sold at loss

If the stock had instead been sold at $7/share, the employee would report a $300 (= $1,000 - $700) LTCL and no compensation would have been recognized.

Example # 3: Holding requirement not met

If the holding period had not been met, the employee would report ordinary income of $500 (= $ 1,500 - $1,000) and a LTCL of $800 (= $700 – $1,500).

3. Non-statutory Stock Options

These options are taxed as compensation on the grant date if the option has a readily determinable FMV and the option is transferable or not subject to forfeiture should the employee fail to comply with specific conditions imposed. The income recognized is the difference between the FMV of the option and the price paid for it, if any. This amount is reported on Form W-2, Box 1.

[23] *Section 83(b) Election Not Always a Good Idea*, Chris Novak, TAXPRO Monthly, August 2009.

[24] IRC § 423.

If the FMV cannot be determined on the grant date, recognition of income is postponed until the option is either exercised or transferred.

The basis of the stock acquired equals the amount paid for the option plus any amount the employee is required to include in income.

4. Summary of Tax Treatment

While the facts of situation below merely repeat the examples given in the text above, I am providing a side-by-side comparison so that you may readily identify the tax treatments distinct to each type of employee stock option. Additionally, I have assigned letters to each part of the transaction so that you have a standardized algorithm that can be applied to any taxpayer's situation.

Facts of the Situation:

2/15/09: Option granted to buy 100 shares of XYZ at $10/share (G) when FMV of stock = $12/share (F)
10/1/11: Option exercised when FMV of stock = $15/share (E)

Stock is then sold at either $16/share (Sg) for a gain
...or $7/share for a loss (Sl).

ISO LT hold met	ISO LT hold not met
No compensation Sg – G =$600 LTCG *(Net = $600)*	E – G = $500 Ordinary Sg – E = $100 LTCG *(Net = $600)*

ESPP LT hold met; sold at gain	ESPP LT hold not met; sold at gain	ESPP LT hold met; sold at loss	ESPP LT hold not met; sold at loss
F – G = $200 Ordinary Sg – F = $400 LTCG *(Net = $600)*	E – G = $500 Ordinary Sg – F = $100 LTCG *(Net = $600)*	No compensation Sl – G = $300 LTCL *(Net = $300)*	E – G = $500 Ordinary Sl - E = $800 LTCL *(Net = $300)*

Non-statutory Options
F – G = $500 Ordinary Sg – E = $100 LTCG *(Net = $600)*

VI. Restricted Stock[25]

Often given to an employee at no cost, company stock may be subject to restrictions, such as forfeiture if the employee fails to meet requirements imposed upon him, such as a term of years. When this restricted stock[26] is transferred to an employee as payment for services, the employee's income and the employer's deductions are not recognized until vesting occurs (i.e., until the stock is no longer restricted). Alternatively, the employee may elect under §83(b) to recognize the income on the date of the stock's receipt rather than on the date of its vesting.

Without the election, the restricted stock results in compensation income to the employee in the year the forfeiture restriction lapses or the stock becomes transferable. The amount included in income (subject to payroll tax withholdings) is the excess of the stock's value when the restriction lapses over the amount, if any, paid for the stock by the employee.

Instead, an employee may elect to recognize income in the year he receives the restricted stock as per §83(b). The amount included in income (again, subject to payroll tax withholdings) is the excess of the stock's value upon receipt over the amount, if any, the employee paid for the stock.

<u>Tax Consequences of the §83(b) Election</u>

- The employee must recognize compensation income on the date of transfer, but receives no cash with which to pay the resulting tax. If the stock is subsequently forfeited, the employee can't claim a deduction for the previously recognized income; however, any amount paid for the stock may be deducted as a capital loss.
- Any appreciation in the stock's value after the date of transfer is taxed as capital gain when the stock is ultimately sold. The employee's holding period begins on the date of transfer.
- The employee is treated as the owner of the stock and, therefore, dividends on the stock are treated as such rather than compensation income. Qualified dividends are taxed at a maximum federal rate of 15%.
- There are no tax consequences when the stock vests. Appreciation between the transfer date and vesting date is not recognized until the stock is sold.

The election is best made when the shares given to the employee have nominal value on the date of transfer, or the employee pays full or substantial value for the stock, or significant appreciation between the date of receipt and the time that the stock vests is anticipated. On the other hand, it is best to *not* make the election where the employee would be required to recognize substantial income upon receipt of the stock, or the employee will likely fail to satisfy the conditions creating the substantial risk of forfeiture.

[25] Rule 144 of The Securities Act of 1933. NOTE: The holding period limiting the resale of restricted securities has been shortened from 2 years to only 6 months, effective February 15, 2008.

[26] Stock is considered substantially not vested (restricted) where the recipient risks forfeiture conditioned (directly or indirectly) upon the future (non)performance of substantial employment services AND where the stock is not transferable (i.e. the transferee is subject to the same forfeiture conditions as the employee). IRC § 83(c).

VII. Mineral Rights

The extraction of natural resources by someone other than the owner of these mineral rights may be classified either as a sale or as a lease. Proper classification may be determined by applying an economic interest test and determining if the owner of the land is paid regardless of whether the extracted mineral is sold. If so, he is deemed to have relinquished his rights (and therefore, his economic interest) and so the transaction will be classified as a sale. If, on the other hand, the landowner's payment is sourced to the proceeds from the sale of the mineral, the landowner has retained his interest and the transaction is classified as a lease.

Note that the land surrounding the mineral will inevitably have to be accessed and as such, the transaction will have to be bifurcated. Depending on the circumstances, that surrounding land will also be sold or rented.

Once the transaction has been classified, the chart below can be used to apply the proper tax treatment:

	Sale	Lease
Mineral Rights	ST or LTCG in year proceeds are received Basis of the mineral right is usually zero	Royalties reported on Schedule E Landowner may claim percentage depletion
Surface Land	Sale is reported on Schedule D if right-of-way or easement granting perpetual access without possibility of reversion involved	Rental income must be separately identified on Schedule E

VIII. Mark-to-Market Election[27]

Normally an investor is bound by the rules regarding wash sales[28] and capital loss limitations[29] when engaging in the purchase and sale of securities. However, the IRS allows active traders to make an election to report all securities transactions as ordinary income on Form 4797, Part II (rather than on Schedule D) and to transact trades without regard to the wash sale and capital loss limitations otherwise imposed on investors.

The §475 election requires that all securities be treated as sold and repurchased at FMV on the last day of the tax year. Unfortunately, the election for the current year must be made by attaching a statement to the previous year's tax return or extension request by no later than the filing date (<u>excluding</u> extensions). In other words, to make the election for 2011, the taxpayer must make the election by no later than April 15, 2011. Then,

[27] IRC § 475.

[28] IRC § 1091.

[29] IRC § 1211.

when filing the 2011 return in 2012, Form 3115 Application to Change Accounting Method must be attached to the return.[30]

To allow for additional time, some practitioners have advised taxpayers to create a new pass-through entity, such as a partnership or S-Corporation, to conduct the trading activity. In this fashion, the taxpayer need not submit his election with the prior year's return, but can instead record the §475 Election on the company books within 2-½ months after the start of the entity's first taxable year. A copy of this statement must then be attached to the first-year tax return.

The IRS distinguishes between investors, traders, and dealers in the following manner:

- **Investor:** Typically, an investor buys and sells securities for capital appreciation and is not concerned with short-term fluctuations in the market. A taxpayer will be presumed to be an investor unless he (or the facts and circumstances of the situation) can satisfactorily demonstrate that he is actively engaged in a trade or business.
- **Trader:** A trader is engaged in the business of buying and selling securities for his own account and seeks to profit from daily market movements, rather than from interest or dividends. He carries on the activity with continuity and regularity and the activity is substantial.
- **Dealer:** This individual has a place of business and buys and sells securities to and from customers with the intent of reaping a profit on mark-ups and mark-downs.

It is often hard to determine the taxpayer's status. Many of today's day-traders sitting at home and gleefully punching the keyboard to do their trading via the internet pretend to qualify, but the following factors should be considered when making the determination:

1) Holding periods
2) Trading frequency and volume
3) Time devoted to the activity
4) Profitability
5) The extent to which this activity supports the taxpayer
6) Business-like record keeping
7) Minimal dividend or interest income earned

The practitioner must make sure to carefully consider the client's circumstances. To qualify as a "trader," the trading activity must be regular, continuous, extensive, and intended for short-swing profit. Most taxpayers will not qualify under the stringent case-law criteria and should be treated as "investors."

<u>Court Rulings and other Findings:</u>

- A taxpayer who traded over 1 million shares in over 1,000 transactions and incurred a margin debt of over $40 million still did *not* qualify as a "trader" since he made

[30] A full-time securities trader was denied the §475 election which he failed to make on a timely basis based on insufficient advice received from his tax professional (PLR 200209052). Similarly, the taxpayer in *Lehrer v Commissioner*, No. 06-75584 (9th Circ. May 23, 2008) was denied his mark-to-market election since he did not make the election as outlined in Rev. Proc. 99-17.

fewer than 100 sales transactions per year, received dividends and interest, and hoped to realize a long-term capital gain.[31]

- Taxpayer was denied classification as a "trader" since 2/3 of his portfolio was held for more than 6 months, indicating that he did not expect to capitalize on daily or short-term market swings.[32]
- Another taxpayer was denied "trader" status because his trading activity was *irregular* throughout the year.[33]
- A taxpayer who traded throughout the year was denied "trader" status because he only traded on 45% of all available trading days throughout the year and generally held each of his positions for more than 31 days.[34]
- On the other hand, this taxpayer qualified as a "trader" because he was considered to have been engaged in a business when he traded 11,040 futures contracts in one year and 6,711 contracts in the next, generally behaving as a speculator uninterested in earning income from interest, dividends, long-term capital gains.[35]
- But investing in high-risk or non-income-generating securities is not enough to be classified as a "trader." The taxpayer must prove that his losses are directly related to his trade or business.[36]
- Investment clubs do not qualify as a trade or business.[37]

	Form to report Gain/Loss	Form to report Expenses	Form to report Margin Int.	Hobby Loss Rule[iii]	Home Office Deduction	SE Tax	Eligible for IRA	Wash Sale	$3K Loss Limitation
Investor	D	A	A	No	No	No	No	Yes	Yes
Trader	D	C [ii]	C [ii]	Yes	Yes	No	No	Yes	Yes
Dealer [i]	C	C	C	Yes	Yes	Yes	Yes	No	No
MTM Trader	4797, Part II	C [ii]	C [ii]	Yes	Yes	No	No	No	No

[i] NOTE: Dealers are *required* to follow mark-to-market rules. Traders may *elect* to use them.
[ii] If Trader or MTM Trader do not materially participate in the endeavor, interest expenses must be reported on Form 4952 Investment Interest Expense Deduction; all other expenses are non-passive losses (reportable on Schedule E, if the trader is a limited partner).
[iii] IRC § 183.

[31] 55 TCM 1101.

[32] 67 TCM 2949.

[33] 62 TCM 275.

[34] TCM 2008-191.

[35] 89 TX 445.

[36] 79-1 USTC 9331.

[37] Rev Rul 75-523.

IX. Capital Gains Treatment under Alternative Minimum Tax

So far, we have discussed the treatment of capital transactions under regular income tax provisions. Now, we must turn to the rates and rules of the parallel system known as the Alternative Minimum Tax (AMT).

A. ISOs and AMT

Although the exercise of an ISO is generally not a taxable event, the bargain element is includible in Alternative Minimum Taxable Income (AMTI). Defined as the difference between the fair market value of the stock on the date of exercise and the actual purchase price of the stock using the option, the bargain element represents the savings enjoyed by the option holder who has the opportunity—due to his option—to purchase the stock for less than the prevailing market price. The taxpayer must include this "savings" as an AMT tax preference item.[38]

Due to differing treatment under the regular and the AMT tax systems, a taxpayer may well have two different bases for the same shares of stock: His regular tax basis will be the exercise price at which he purchased the stock with the help of the ISO. His AMT basis, on the other hand, will be the exercise price plus the includible AMTI income.

B. Net Operating Losses

A Net Operating Loss (NOL) results when allowable deductions exceed gross income.[39] However, capital losses in excess of capital gains are excluded from NOL computations. (Of course, $3,000 of these excess capital losses may still be deducted against ordinary income and any remaining losses may be carried forward indefinitely, but not back).

For AMT purposes, taxpayers must recompute the NOL to arrive at the Alternative Tax Net Operating Loss (ATNOL), beginning with the regularly computed NOL and making adjustments as mandated by IRS §§ 56, 57, and 58.

While the Code does not specifically address the issue of an AMT capital loss, the Tax and 5th Circuit Courts have concluded that because ATNOL is merely a modified NOL, capital loss limitations remain unchanged. As a result, ATNOLs resulting from capital losses may—like their regular capital loss counter-parts—not be carried back to offset AMT capital gains in earlier years (as learned the hard way by a California taxpayer[40]).

[38] IRC § 56(b)(3).

[39] IRC § 172.

[40] *Merlo*, 100 AFTR 2d: Saddled with a huge AMT tax liability in 2000 (due to the exercise of an ISO), the taxpayer sought to offset this liability with an ATNOL incurred in 2001 when his stock became worthless as the high-tech bubble burst.

Although Merlo lost, a provision of the Tax Relief and Health Care Act of 2006 now grants relief to similarly situated taxpayers by offering a refundable AMT credit [41] for 2007 and beyond.

X. New Forms for 2011 and Beyond…

Throughout this text, I have referred to Schedule D for purposes of reporting gains and losses resulting from capital transactions. Of course, we already know that Schedule D has been significantly revised and now serves merely to summarize capital transactions reported on the new Form 8949, Sales and Other Dispositions of Capital Assets.

Form 8949 is still divided into short- and long-term sections and used to report transactions with holding periods less than or more than one year, respectively. However, this form further segregates all transactions into three categories:

(A) Long-term transactions reported on Form 1099-B with basis reported to the IRS
(B) Long-term transactions reported on Form 1099-B but basis not reported to the IRS
(C) Long-term transactions for which you cannot check box A or B

Taxpayers will check off the appropriate box depending on whether or not their brokers have included cost basis information on Form 1099-B. Brokerage firms are required to report adjusted basis information as well as quantities sold, sales prices, commissions, holding periods, short sales, disallowed losses due to wash sales, and corporate mergers for all "covered securities".[42]

Securities currently subject to these new reporting requirements include stock, and other financial instruments as designated by the Department of Treasury which were purchased on or after January 1, 2011. Therefore, only a limited number of transactions are required to be categorized as "A" on 2011 tax returns. Sales of regulated investment companies and shares acquired through dividend reinvestment plans (if acquired on or after January 1, 2012) will be added to the new reporting requirements on 2012 returns and beyond; reporting of options and debt instruments has recently been delayed from January 1, 2013 to January 1, 2014.[43] In this manner, the onus of cost basis tracking is shifted from the taxpayer to the broker in hopes of simplifying the IRS' verification tasks. But the process is intended to be implemented incrementally and promises to be cumbersome during the phase-in period.

Nevertheless, it is important to note that all securities discussed in this text fall within the new mandate and are, therefore, reportable first on Forms 4797 (if interbank transactions or subject to the mark-to-market election) and 8949 (all others) rather than directly on Schedule D.

[41] IRC § 53(e)(1).

[42] Instructions for Form 1099-B, Department of the Treasury, Internal Revenue Service, Cat. No. 64171A.

[43] IRS Notice 2012-34.

CORRECTIONS

Tax Consequences for Writer (Page 8)

Example

	Sales Price of Stock	*$1400*
–	*Cost of Stock $1317 + Commissions $50 - $202 Premium*	*1165*
=	*Realized Gain*	*$235*

Summary of Tax Consequences (Page 10)

	Expiration	Exercise	Close Out
Call Holder [*may* buy stock]	STCL (= prem. out)	ST or LT after disposition of stock Basis of stock = strike + prem. out	ST or LT (= prem. in – prem. out)
Put Holder [*may* sell stock]	STCL (= prem. out)	ST or LT (= strike – basis) Basis of stock = cost + prem. out	ST or LT (= prem. in – prem. out)
Call Writer [*must* sell stock]	STCG (= prem. in)	ST or LT (= strike – basis) Basis of stock = cost – prem. in	ST or LT (= prem. in – prem. out)
Put Writer [*must* buy stock]	STCG (= prem. in)	ST or LT after disposition of stock Basis of stock = strike – prem. in	ST or LT (= prem. in – prem. out)

ISOs (Page 16)

Example # 3: Holding requirement met & stock sold at loss
Alternatively, if the stock had been sold at a loss, no compensation would have been recognized and the employee would have reported a LTCL.

ESPPs (Page 17)

*Example # 1: Holding requirement **not** met*
On February 15, 2009 XYZ granted an ESPP option to buy 100 shares at $10/share when the FMV was $12/share. Employee exercised the option on October 1, 2011 when the FMV of the stock was $15/share. Employee then sold the stock almost immediately for $16/share.
The long-term holding period requirements were not met and so the employee would report ordinary income of $500 (= $1,500 - $1,000) and a STCG of $100 (= $1,600 – $1,500).
Example # 2: Holding requirement met
If the holding periods had been met, the employee would report $200 (= $1,200 - $1,000) as ordinary income and $400 (= $1,600 - $1,200) as LTCG.
Example # 3: Holding requirement met & stock sold at loss
If the stock had instead been sold at $7/share, the employee would report a $300 (= $1,000 - $700) LTCL and no compensation would have been recognized.

Summary (Page 18)

ISO LT hold not met	ESPP LT hold not met; sold at loss
E – G = $500 Ordinary Sg – E = $100 STCG *(Net = $600)*	E – G = $500 Ordinary Sl - E = $800 STCL *(Net = $300)*