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More options taxation oddities

Not all such investments are similarly taxed, so take advantage when you can

By Robert N. Gordon

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My recent column on the taxation of listed options on SPDR Gold Shares (GLD) seems to have struck a nerve. Many practitioners were incredulous. How, they asked, could the option on a security possibly be taxed more favorably than the underlying security?

But here, again, are the facts: Short-term gains on GLD are taxed at 35%, long-term gains on GLD are taxed at 28% (as a collectible), and profits on GLD's listed options are taxed at a blended rate of just 23%. It may not make much sense, but that is how a “non-equity” option is taxed.

Here is why. A non-equity option is an Internal Revenue Code Section 1256 contract. All financial products governed by Section 1256 are marked to market at the end of a taxpayer's fiscal year.

Due to the dramatic changes in the way that contracts covered by the section would be treated for tax purposes, including the year-end mark-to-market rule, a compromise was reached so that Section 1256 assumes that all profits are automatically taxed as if 60% of the gain were long term and the remaining 40% short term. This combination creates a 23% rate under current tax rates.

For example, if an investor had $1,000 of Section 1256 gain, $600 would be taxed at the 15% long-term rate (a tax of $90), and $400 would be taxed at the 35% short-term rate ($140), for a total tax of $230 (23% of the $1,000 Section 1256 profit).

The devil is in the details regarding which financial products come under the Section 1256 umbrella and which don't.

Section 1256 applies to exchange-traded, non-equity options such as listed options on broad-based indexes. OTC options on the very same broad-based indexes aren't.

Section 1256 contracts. As a result, an investor purchasing a listed S&P 500 option on an exchange will find himself or herself in a different tax regime from an investor purchasing a similar OTC option directly from a dealer.

If an investor's time horizon for a long position is less than one year, financial products that fall under Section 1256 produce more after-tax profits than those assets that are taxed “normally.” If the time horizon for a long position is greater than one year, options that are taxed “normally” at 15% are a better choice than those under Section 1256's blended tax rate of 23%.

Even more confusing is the taxation of options on ETFs. Listed single-stock options, as well as narrow-based index options, aren't Section 1256 contracts.

As a result, they are taxed “normally.”

Although the tax authorities haven't issued a definitive ruling, we have been advised that listed options on exchange-traded funds are taxed like options on single stocks. Therefore, a listed option on the S&P 500 index is a Section 1256 contract, while a listed option on the S&P 500 ETF isn't.

So why is a listed option on the gold ETF a Section 1256 contract?

Technically, GLD isn't a simple ETF; it is actually an exchange-traded grantor trust. For tax purposes, a grantor trust is disregarded as an entity, and that is why the tax section of the GLD prospectus warns investors that long-term gains are not taxed at 15% but at the 28% long-term rate that governs collectibles.

Holding GLD is equivalent taxwise to holding physical gold. An option on GLD is an option on gold, or at a minimum, an option on something that isn't an equity.

Either way, it is a Section 1256 contract.

Investors can be sure that OTC options and single-stock options will be taxed “normally.” But once an investor starts using listed options, help them determine upfront which tax regime they prefer given their time horizon for the investment.

It may be complicated, but there are tax savings available just by being choosy about which options you use.

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