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***THE TAX-CONSCIOUS ADVISER***
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# New cost-basis rules for options

*Problems can arise because of a gap between tax laws and what a broker must report to clients*


It's the beginning of the year and you and your clients are starting to receive an avalanche of forms and reports from brokerage firms and custodians. You'll see some new information this season as 2014 was the first year that brokers had to start reporting on transactions in options and (simple) debt instruments.

This is the third phase of implementing the cost-basis reporting law contained in the 2008 Energy Act. This rule ushered in a new regime under which brokers were required to start to report not only gross sales amounts, but also cost basis for equities purchased after Jan. 1, 2011. Cost basis for anything bought before 2011 is not reported. If you sold a security for a profit in 2014 that you bought in 2009, cost basis (and therefore gain) will not be reported, although there clearly is a gain that requires a tax computation.

Mutual funds and most exchange-traded funds were included in 2012. Both over-the-counter and exchange-traded options were included as of Jan. 1, 2014. Simple straight debt was also included as of the beginning of 2014 with convertible bonds and “structured notes” scheduled for inclusion in 2016.

## DIFFERENT RULES

A problem can arise because there is a wide gap between what the tax laws are and the rules on what a broker or custodian has to report. CPA Robert Green states, “Securities brokerage firm profit and loss reports and their Form 1099Bs are prepared by brokerage firm accountants and IT people to meet the brokerage firm's tax compliance rules with the IRS. As it turns out, the IRS rules for taxpayers are very different from brokerage firm rules."

As an example, brokerage firms now have to report wash sales to the IRS. The brokerage firms are to report only wash sales in the exact same security and in the exact same account. If you sold in one account and repurchased in another account (even with the same broker) no wash sale would be reported even though a wash sale had occurred. If you sell an equity for a loss and subsequently buy a call option on the same company, that clearly violates the wash sale rule yet it would not be reported as a wash sale because they do not have the same CUSIP code.

If you sell in your individual account and repurchase in your IRA, that again is clearly a wash sale but it will not be reported under the regime spelled out for the brokers. Just because there are no wash sales reported, it doesn't mean you didn't have any wash sales.

On the flip side, those who frequently trade in and out of the same security could have each subsequent wash sale reported over and over again making the "broker-reported wash sale amount" much too large.

The reporting of basis on options was to phase in earlier than 2014, but there were complications that made the IRS postpone the reporting until then.

One of the problems is that there are two distinct regimes for taxation of options. Options on equities are taxed "normally" while exchange-traded non-equity options are taxed as futures — marked to market at year-end with 60% to be taxed as long-term and 40% as short-term gain or loss. There was enough confusion about what is and isn't a 1256 contract that brokers are instructed to make their best efforts and are granted penalty relief if they get it wrong.

A 1256 option contract is one that is traded on an exchange in which the underlying reference investment is not an equity. Options on narrow-based indexes are also not 1256 contracts. Over-the-counter options are not Section 1256 contracts.

## NON-EQUITY OPTIONS

An option on a stock clearly is an equity option. An option on the S&P 500 is clearly a 1256 contract and exactly what the law was intended to include. But the law also grants 1256 status to non-equity options or options on anything but an equity.

Which ETFs are equities and which are non-equities? Because a mutual fund is an equity, exchange-traded options of the S&P 500 ETF would not be a 1256 contract. GLD, the gold ETF, is a grantor trust that holds physical gold and clearly is not an equity. Therefore, exchange-traded options on GLD should be taxed as 1256 contracts. Each ETF will need to be analyzed by the reporting entity once a client uses options on that ETF.

Be warned, broker reporting, though well intentioned, is only a starting point in calculating your taxes.

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