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Best Ways to Take the Tax Bite Out of Call Options

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Is your client planning to do something as simple as buying a call option on the S&P 500? You may be surprised to learn there are various ways to do that and that each has its own taxation structure.

The taxation of investment profits is driven by the form of the investment, not the underlying referenced investment or index. As an example, all profits from any principal protected note are taxed at the highest rate, as interest income. Therefore, any value received from a principal protected note that also offers upside in the S&P 500 is taxed as interest, even if the profits stem from the index going up.

There are exchange-traded options that are tied to the S&P 500, and there others that are options on the S&P 500 ETF. Options on the ETF are taxed like options on an individual stock, because the ETF is a corporation. If the option is held for less than one year, gains or losses are short-term in nature; if the ETF option is held for more than one year, the gains or losses will be long term.

The taxation of exchange-traded options on an index is an entirely different story; these index options are taxed just like the futures contracts that are traded on the S&P 500. That means the gains and losses are taxed as if 60% of the profits are long term and the other 40% are short term. This creates a maximum tax rate of 31.64%, assuming long-term gains are taxed at the top rate of 23.8% and short-term gains are taxed at the highest rate of 43.4%

This treatment is a trade-off because these listed index options are marked to market for tax purposes every Dec. 31. This is one of only a few circumstances where the realization-based investment taxation regime for individual investors is not the rule.

This tax treatment was put into place in 1981 to combat commodity futures investors from too easily deferring income from one year to the next in mostly offsetting positions; this was the birth of the straddle rules. To stop the perceived abuse, the government created this mark-to-market taxation regime that would effectively eliminate the ability to realize a loss in one year and a corresponding gain in the next year.

The then-head of the Congressional tax-writing committee was from Chicago, and he complained that, if everything was marked to market once a year, it meant all profits would always be short-term in nature. A compromise was struck where only 40% of these profits would be short term.

This is the tax treatment of exchange-traded index options. This is also the tax treatment for any exchange-traded option that is tied to anything but a corporation. Listed options on MLPs are taxed this way, as would be profits from exchange-traded options on the gold ETF, because it is a grantor trust, not a company. The oil ETF is a commodity pool of oil futures; it, too, is not a fund, and thus options on the ETF are taxed on a 60/40 basis as well.

This 60/40 tax treatment is only available to options that trade on the exchange. Over-the-counter options are taxed normally: less than one year, short term and more than one year, long term.

We find that the choice of investment vehicle should be directed by how long you expect to be in the option. If you are going for a quick trade (anything less than a year), it would make sense to pick an option where those short-term profits would be taxed at 31.64% — the index options.

If you thought you might hold for more than a year, the options on the ETF could make more sense. These options would be taxed at a higher rate on short-term profits (43.4% vs. 31.64%) but more favorably on long-term profits (23.8% vs. 31.64%). Furthermore, one could sell a losing option position before one year elapses, capturing short-term losses that could be more valuable to the client than 60/40 losses.

Profits on listed index options will always be taxed better for those who are option writers. When you open a position by selling an option, it is considered a liability, not an asset. You cannot get long-term treatment on a liability, so these profits will always be taxed as short term, even if the option expiration was more than one year.

Bearish advisors and their clients, too, would be better off using exchange-traded options, because short sales are also liabilities that are always taxed as short term. Buying a put option of the S&P 500 will be taxed at 31.64%; a 13-month put option of the S&P 500 ETF could get long-term treatment.

There are obviously many ways for advisors to help clients bet on the market. Why not choose the investment product that could provide the most favorable tax result?