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Options, Puts, and Calls: Tax Planning

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Introduction

The tax rules for options are complicated, to say the least. The tax consequences of an options transaction depends on many factors, including the investor's tax bracket, the type of property that underlies the option (e.g., stocks, bonds, commodity futures, currency contracts), and the nature of the options transaction. While this discussion attempts to shed some light on the subject, investors should consult a tax planning professional before including options in their portfolios, and refer to IRS Publication 550, Investment Income and Expenses.

For this discussion, it's assumed that individuals investing in options understand this form of investing, but the following quick review may be helpful.

Caution: This discussion is focused solely on federal income tax. Options transactions may also trigger state income tax and/or foreign tax consequences.

Caution: Special rules apply to non-equity options and are not discussed here.

Options, puts, and calls--a quick review

An option is a right to buy or sell investment securities at a certain price (the "strike price") on or before a certain date (the "expiration date"). A "call" is an option to buy, and a "put" is an option to sell. The seller (grantor) of the option is the "writer." The buyer of the option is the "holder."

Options are publicly traded on the major exchanges and the over-the-counter market. Investors may buy existing options on the open market, or they may buy newly issued options from the writer by paying a "premium."

The holder is not obligated to buy or sell the underlying securities ("exercise" the option). The holder may let the option expire ("lapse") (in this case, the holder loses the premium) or may sell the option ("trade") on the open market. The writer, however, is obligated to buy or sell the underlying securities in accordance with the option agreement if the holder chooses to exercise the option before the option lapses. If the holder lets the option lapse, the writer's obligation ends and the writer gets to keep the premium (the option becomes worthless). If the holder trades the option on the open market, the writer's position does not change, though the writer's obligation will be to a new holder. Some investors buy or sell back their option rights instead of exchanging the underlying securities ("reversing a position").

An option is "at-the-money" when the underlying securities are currently trading at the same price as the options strike price. If the underlying securities are trading at a higher price, a call option is "in-the-money" ("deep-in-the-money" if the price is substantially higher) and a put option is "out-of-the-money." Conversely, if the underlying securities are trading at a lower price, a call option is "out-of-the-money" and a put option is "in-the-money."

A "straddle" is when an investor either buys or sells a put and a call at the same strike price and expiration date. Straddles are subject to the loss deferral rules (see below for more on this).

A "married put" is when an investor buys a put option and the related underlying securities on the same day (the underlying securities must be identified with the put).

Options--tax basics

Because options represent capital assets, transactions involving options generally result in capital gains or losses.

When an option is exercised, the IRS ignores the length of time the option was held. Whether gain or loss is short term (one year or less) or long term (over one year) is based upon the holding period of the underlying securities.

Option purchases and sales are subject to the wash sale rules (see below for more on this).

Tax consequences for option holders (buyers)

The price you pay to buy an option cannot be deducted as an itemized deduction on your federal income tax return. There is no taxable event until you end the option. To end the option, you may take one of the following actions:

- Exercise the option
- Let the option lapse
- Sell (trade) the option on the open market or reverse your position

Exercising a call option

If you exercise a call option and buy the underlying securities, the price you paid for the option is added to the underlying securities' tax basis (which also includes commissions and fees paid to buy and exercise the option). You will not realize and report a capital gain or loss until you sell the underlying securities. The gain or loss will be the difference between the sale price of the underlying securities and their tax basis. Your holding period on the underlying securities starts on the day the option is exercised, not the day the option was purchased.

Example(s): XYZ stock is currently selling at \$50 per share. Alan believes the stock price will rise, so he buys a call option for 100 shares of XYZ stock on March 3 for a premium of \$1 per share. The strike price is \$50 per share and the expiration date is September 3. On July 10, XYZ stock is selling for \$55 per share. Alan exercises his option, pays \$5,000 and receives 100 shares of XYZ stock. Alan has paid \$300 in commissions and fees to buy and exercise the call. Alan's basis in the stock is \$5,400 (\$100 call option premium plus \$5,000 stock purchase price plus \$300 transaction costs). On October 9, Alan sells his 100 shares of XYZ stock for \$58 per share, or \$5,800. Alan realizes a profit of \$400 (\$5,800 selling price minus \$5,400 basis). Alan's holding period is 3 months (July 10 to October 9). Alan must report a short-term capital gain of \$400 for a taxable event occurring on October 9. Note: this example is for illustrative purposes only and does not reflect the performance of any particular investment.

Exercising a put option

If you exercise a put option and sell the underlying securities, the premium you paid for the option (plus commissions and fees) reduces the amount you realize on the sale of the underlying securities. Determining whether you have a short-term or a long-term gain or loss depends on when you purchase the underlying securities in relation to when you bought the put.

If you sell securities that you had held long term at the time you bought the put, you will have a long-term gain or loss.

Example(s): Jane bought 100 shares of ABC stock on November 6, 2007 for \$25 per share. Her basis in the stock is \$2,600 (increased by commissions and fees she paid to buy the stock). By January of 2009, Jane began to feel that the price of ABC's stock would begin to drop, so she buys a put option for 100 shares on January 10 for \$1 per share. The strike price is \$25 per share and the expiration date is October 10, 2009. Because Jane had held her shares long-term when she buys the put (November 6, 2007 to January 10, 2009), her holding period start date does not change. On June 3, 2009, shares of ABC stock are selling for \$15 per share. On that date, Jane exercises her option and sells her shares for \$2,500. Jane pays \$400 in commissions and fees to buy and exercise the put. Jane realizes a loss of \$600 (\$2,500 selling price minus \$100 put option premium minus \$400 transaction costs minus \$2,600 basis). Jane's holding period is 19 months (November 6, 2007 to June 3, 2009). Jane can report a long-term capital loss for a taxable event occurring on June 3, 2009. Note: this example is for illustrative purposes only and does not represent the performance of any particular investment.

If the put is a married put, the gain or loss will be short-term or long-term, depending on how long you had held the securities before you exercised the put.

Example(s): In November of 2008, Jane believed that the price of ABC stock (currently selling for \$25 per share) would begin to fall. On November 6, 2008, Jane bought a put option for 100 shares at \$1 per share with a strike price of \$25 per share and an expiration date of May 6, 2009. On the same day, Jane bought 100 shares of ABC stock for \$25 per share (she identifies the stock with the option). Her basis in the stock is \$2,600 (increased by commissions and fees she paid to buy the stock). Because Jane bought the shares on the same day as she bought the put (and identified them with the put), her holding period start date is November 6, 2008. On April 3, 2009, shares of ABC stock sold for \$15 per share. On that date, Jane exercised her option and sold her shares for \$2,500. Jane paid \$400 in commissions and fees to buy and exercise the put. Jane realized a loss of \$600 (\$2,500 selling price minus \$100 put option premium minus \$400 transaction costs minus \$2,600 basis). Jane's holding period is 5 months (November 6, 2008 to April 3, 2009). Jane can report a short-term capital loss for a taxable event occurring on April 3, 2009. Note: this example is for illustrative purposes only and does not represent the performance of any particular investment.

If you sell securities you had held short term at the time you bought the put, or if you purchased the securities after you bought the put (but before you exercised the put), the transaction will be treated as a short sale. That is, your holding period for the securities starts on the date you exercise the option, regardless of when you actually bought them.

Example(s): Jane bought 100 shares of ABC stock on November 6, 2007 for \$25 per share. Her basis in the stock is \$2,600 (increased by commissions and fees she paid to buy the stock). On September 8, 2008, Jane felt that the price of ABC's stock would begin to drop, so she bought a put option for 100 shares on January 10 for \$1 per share. The strike price was \$25 per share and the expiration date was March 8, 2009. Because Jane had held her shares short-term when she bought the put (November 6, 2007 to September 8, 2008), her holding period start date changes to the date she exercises her option. On February 7, 2009, shares of ABC stock were selling for \$15 per share. On that date, Jane exercised her option and sold her shares for \$2,500. Jane paid \$400 in commissions and fees to buy and exercise the put. Jane realized a loss of \$600 (\$2,500 selling price minus \$100 put option premium minus \$400 transaction costs minus \$2,600 basis). Under the short sale rule, Jane's holding period is zero months (February 7, 2009 to February 7, 2009). Jane's loss is short term, regardless of the fact that she purchased the shares on November 6, 2007. Note: this example is for illustrative purposes only and does not represent the performance of any particular investment.

Letting the option lapse

If you allow an option to expire unexercised, it is deemed sold for zero dollars on the expiration date (unless it is a married put, see below). You will have a loss in the amount of the premium price plus commissions and fees you paid to buy the option. Generally, whether your loss is short term or long term will depend on how long you held the option.

If the expired option is a call option, you will have a short-term loss if you held the option for one year or less or a long-term loss if you held the option for more than one year.

If the expired option is a put option for securities you had held long-term at the time you bought the option, you will have a long-term loss if you have held the option long term. You will keep the securities and their holding period start date remains unchanged--it's the date you bought the securities.

Example(s): Kevin bought 100 shares of AAA stock on October 15, 2007. On November 15, 2008, Kevin bought a put option for the shares at \$1 per share (plus \$100 in commissions and fees). The put lapsed December 1, 2009. Kevin's loss of \$200 is long term because he had held the shares long term when he bought the put, and because he held the option long term.

If the expired option is a put option for securities you had held short-term at the time you bought the put (or after you bought the put), you will have a short-term loss, regardless of how long you have held the option. Moreover, the holding period start date for the underlying securities changes to the date the put was purchased.

Example(s): Kevin bought 100 shares of AAA stock on October 15, 2007. On November 15, 2008, Kevin bought a put option for the shares at \$1 per share (plus \$100 in commissions and fees). The put lapsed December 1, 2009. Kevin's loss of \$200 is short term even though he held the option long term because he had held the shares short term when he bought the put. Further, Kevin's holding period start date for the shares changed to November 15, 2008.

If the expired option is a married put, no loss results. The cost of the put (plus transaction costs) is added to the basis of the underlying securities with which it is identified. Your holding period start date for the securities remains unchanged--it's the date you bought the put and the securities.

Tip: Most options expire within a few months, so most losses will be short term. However, a form of puts and calls, called LEAPS, may have an expiration date of more than one year, resulting in a long-term loss.

Trading the option (or reversing your position)

The sale (trade) of an option on the open market (or back to the writer if you're reversing your position) prior to the option's expiration date will result in either a gain or a loss, depending on the amount you receive for the trade (minus commissions and fees paid for the trade) in relation to the premium you paid for the option (plus commissions and fees paid to buy the option). Generally, you will have either a short-term or long-term gain or loss based on the holding period of the option.

If you sell an acquired call option, you will have a short-term loss if you have held the option for one year or less or a long-term loss if you have held the option for more than one year.

If you sell an acquired put option for securities you had held long-term at the time you bought the option, you will have a long-term gain or loss if you have held the option long term. The holding period start date for the underlying securities remains unchanged--it's the date you bought the securities.

Example(s): Kevin bought 100 shares of AAA stock on October 15, 2007. On November 15, 2008, Kevin bought a put option for the shares. On December 1, 2009, Kevin sold the put on the open market. Kevin's gain or loss is long term because he had held the shares long term when he bought the put, and because he held the option long term.

If you sell an acquired put option for securities you had held short-term at the time you bought the put (or after you bought the put), you will have a short-term gain or loss, regardless of how long you have held the option. Moreover, the holding period start date for the underlying securities changes to the date the put was purchased.

Example(s): Kevin bought 100 shares of AAA stock on October 15, 2008. On November 15, 2008, Kevin bought a put option for the shares. On December 1, 2009, Kevin sold the put on the open market. Kevin's gain or loss is short term even though he held the option long term because he had held the shares short term when he bought the put. Further, Kevin's holding period start date for the shares changed to November 15, 2008.

If the put is a married put, the marriage will be dissolved on the date of the trade. You will keep the underlying securities and your holding period start date will remain unchanged--it's the date you purchased the securities and the put.

Impact of the wash sale rules on option holders

Under the wash sale rules, if an investor buys securities within 30 days before or after the sale of securities that are "substantially identical," the investor cannot claim any loss on the sale. Instead, the investor can increase the basis of the replacement securities by the amount of the loss. The holding period start date for the replacement securities is the holding period start date of the sold securities.

Example(s): Mary buys 100 shares of ZZZ stock on December 12, 2008. Mary sells the shares on May 6, 2009 at a loss of \$600. Mary buys 100 shares of ZZZ stock on May 29, 2009 for \$1,000.

Mary cannot claim the loss. Instead, Mary can increase the cost basis of her new ZZZ shares to \$1,600 (plus transaction costs). Her holding period for the replacement shares starts on December 12, 2008.

The wash sale rules apply when options are bought and sold. Below are some of the ways they relate to option holders.

If you buy a call option and sell "substantially identical" securities within the statutory period at a loss, the loss will be disallowed. The loss increases the cost of the call, and the holding period of the sold securities can be "tacked" onto the holding period of the call. If the call is subsequently exercised and you buy the underlying securities, however, the holding period of the sold securities cannot be "tacked" onto the newly purchased securities--their holding period starts on the date the call is exercised (as with the exercise of any call option).

Example(s): Mary buys 100 shares of ZZZ stock on December 12, 2008. Mary sells the shares on May 6, 2009 at a loss of \$600. Mary buys a call option for 100 shares of ZZZ stock on May 29, 2009 for \$100. Mary cannot claim the loss. Instead, Mary can add the loss to the premium she paid for the call option (plus transaction costs). The holding period of the call starts on December 12, 2008 (the holding period start date of the original shares). Mary exercises the call on July 11, 2009. Her basis in the newly purchased stock is the purchase price plus \$600 (carryover loss) plus \$100 (premium) plus transaction costs. Her holding period for the newly purchased shares starts July 11, 2009.

Similarly, if you sell an acquired call option at a loss and buy "substantially identical" securities within the statutory period, the loss will be disallowed.

If you sell securities at a loss and buy a put option for "substantially identical securities" within the statutory, the loss will be disallowed.

If you sell an option (call or put) on the open market at a loss, and purchase a "substantially identical" option within 30 days before or after the sale, the loss will be disallowed.

Example(s): Mary buys an option on May 3, 2009, then sells it on the open market on August 14, 2009 at a loss of \$40. 25 days later, Mary buys a "substantially identical" option. Mary's loss is disallowed for this transaction. Instead, Mary's loss can be added to the premium (plus transaction fees) Mary pays for the replacement option. Subsequent tax treatment will depend on whether Mary exercises the option, lets the option lapse, or sells the option (see above).

Caution: It's unclear what "substantially identical" means for purposes of the wash sale rule. A good rule of thumb may be to consider whether the loss and replacement transactions change your position within the market place. If they don't, it's probably a wash sale.

Impact of the loss deferral (anti-straddle) rules on option holder

The loss deferral rules prevent investors from using offsetting positions (straddles) with respect to "substantially identical" securities that "substantially reduce risk" to defer the recognition of gains or to turn a short-term gain into a long-term gain, which would be taxed at preferential rates. If you simultaneously buy a call option and a put option for the same securities at the same strike price and expiration date, you may be holding such offsetting positions. If the loss deferral rules are triggered, generally, you will only be able to deduct a loss on one position to the extent the loss exceeds any unrecognized gain on the offsetting position.

Example(s): Bob buys a put and a call (a straddle position) on June 1, 2008. On December 2, 2008, Bob closes one of the positions at a loss of \$15,000. On December 31, 2008, Bob has unrealized gain of \$11,000 for the offsetting position. Bob can only deduct a loss \$4,000 on his 2008 tax return. Bob must carry forward the balance of the loss, \$11,000 to the 2009 tax year.

Caution: It is unclear what "substantial reduction of risk" means for purposes of the loss deferral rules. It is generally determined on a case-by-case basis.

Tax consequences for option writers (sellers)

If you write (grant) a call or a put, do not include the premium you receive for writing it in your income at the time of receipt. Carry it in a deferred account until one of the following events occur:

- The holder exercises the option
- The holder lets the option lapse
- You reverse your position or close the transaction

When the holder exercises the option

If you've granted a call option and the holder buys the underlying securities from you, you will add the amount of the premium to the amount of the sale proceeds (minus commissions and fees you paid to write the option). You will have a capital gain on the sale of the underlying securities if the total is more than your basis in the securities, or a loss if the total is less than your basis. The holding period of the underlying securities (from the date you bought the securities to the date the holder exercised the call option) will determine if the gain or loss is short term or long term.

If you've granted a put option, you will acquire the underlying securities from the holder. You will not realize a gain or loss at this time. Your basis in the securities will be the purchase price minus the premium you received for the put option (and increased by any commissions and fees you paid). Your holding period for the securities begins on the date you buy the securities, not the date you wrote the put.

When the holder lets the option lapse

If the holder lets the option lapse, your obligation expires and the amount you received for writing the call or put (less commissions and fees you paid to write the option) is a short-term capital gain in the year the option lapses, regardless of how long the option was outstanding.

When you reverse your position or close the transaction

If you buy back the option from the writer, or buy an identical option to offset your position, you will have a short-term gain or loss for the difference between the premium you received (less commissions and fees you paid to write the option) and amount you pay (plus commissions and fees) to buy back the option from the holder or to buy an identical option from another writer.

Impact of the wash sale rules on option writers

If you sell securities at a loss and sell a put option for "substantially identical securities" that is deep-in-the-money within 30 days before or after the sale, you may trigger the wash sale rules (explained above).

Example(s): John sells 100 shares of BBB stock at a loss on February 13. On March 1, John writes a put option giving the holder the right to sell to John 100 shares of BBB stock at a price that is substantially higher than the stock's current market price. John's loss will be disallowed.

Caution: It is unclear how deep-in-the-money the put option has to be to trigger the wash sale rule. However, if at the time the put option is granted there appears to be no likelihood that the put will not be exercised, the wash sale rule will probably apply.

Tax consequences of writing a straddle

An investor may write a put and a call for the same securities at the same strike price and expiration date. The straddle will be taxed according to its respective components. The writer must take care to allocate the premiums

received to the appropriate option. If the premiums cannot be separately identified, the investor may allocate the premium based on the market values of the components. The straddle will also be subject to the loss deferral (anti-straddle) rules (explained above).

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