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Taxation of Stock Options Held by Investors: What to Know

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When it comes to the taxation of stock options, the Internal Revenue Code (Code) does not define capital assets. Rather, it identifies those assets that are *not* capital assets.

Code §1221 provides that "ordinary assets" include, in relevant part, property held by the taxpayer (1) as stock in trade, (2) as inventory, or (3) held for sale to customers in the ordinary course of business. All assets not enumerated in Code §1221 are treated as capital assets. Because investment assets are not held for business reasons, derivatives related to investment activities are treated as capital assets, and gain and loss on derivatives is capital gain or loss. Investment expenses are not attributable to a trade or business so they are not deductible under Code §162.

Taxation of Capital Assets

If an investor holds a capital asset for more than one year, gain or loss on its sale or exchange is taxed at the long-term capital gain rate. The highest current tax bracket for long-term capital gain is 20 percent, compared to 37 percent for the highest ordinary income bracket.[1] This spread between the tax rates for capital assets and ordinary assets means that being taxed as an investor has significant tax consequences.

Three types of stock options are popular with investors: options on individual stocks, options on narrow-based stock indices, and options on broad-based stock indices. Individual stocks and narrow-based stock indices are taxed as "equity options." They are taxed differently from certain broad-based stock indices that are taxed as "non-equity options."

Taxation of Stock Options

Options are contracts entered into between two parties through private negotiation (over-the-counter) transactions or through a public transaction on a securities or commodities exchange (exchange-traded) transactions. A long option (one that an investor has purchased) is the right, but not the obligation, to buy (or sell) the underlying asset at a pre-determined price (the strike price) on or before the option's maturity (the expiration date).

For example, a long call option on XYZ stock is the right to buy that stock at the option's strike price on or before the expiration date, typically no more than a year in the future. A long put option on XYZ stock is the right to sell that stock at the strike price on or before the expiration date.[2] The investor who sells an option on XYZ stock creates the obligation to sell (with a call) or purchase (with a put) the stock that underlies the option if the holder of the long option (buyer) exercises the option.

There are thus two parties to an option contract: the buyer or holder (long side) and the seller or writer (short side). An option expires worthless if the buyer of a call option can buy the stock cheaper in the market than by exercising the option, or the buyer of a put option can sell the stock at a higher price in the market than the buyer would receive if the buyer exercised the option and delivered the shares at the strike price. If the market price of the underlying stock moves favorably for the buyer (up if she is long a call or down if she is long a put), she will exercise the option resulting in the purchase (call) or sale (put) of the underlying stock at the strike price. If the market price moves against the buyer, the buyer will simply let the option expire worthless. The call buyer is protected against increased stock prices but can benefit from lower market prices. Put buyers are protected against lower stock prices but can benefit from higher market prices. As a result, to obtain this one-sided market protection, option buyers pay a premium to the seller to enter into the option.

In what follows, let's first look at the taxation of equity options, and then at those options that are taxed as nonequity options.

Taxation of Equity Options

For tax purposes, if the buyer of an equity call exercises the option, the seller must deliver the shares, and the seller is treated as having sold the shares to the buyer. An investor who sells a call has a short-term or long-term capital gain or loss on the delivered shares, depending on how long the investor held the delivered shares. The holding period for the stock is relevant, and the holding period for the option is irrelevant in computing tax on this transaction. A call buyer who purchases shares by exercising a call option has a tax basis in the shares equal to premium the investor paid for the option plus the exercise price of the shares.[3]

This same treatment applies to buyers and sellers of put options. Buyers who exercise put options deliver the shares to the option seller.

If an option (call or put) expires worthless, stock does not change hands. When the option expires, the premium paid by the buyer is capital gain to the seller and capital loss to the buyer. For the buyer, loss on the premium paid to buy the option is long-term or short-term capital loss, depending on how long the buyer held the option. For the seller, capital gain from the premium received on the sale of the option is always short-term, without regard to how long the seller actually held the option.

For cash-settled equity options, gain or loss is determined by adding the premium paid (received) to the cash paid (received). Buyers receive long-term or short-term capital gain or loss, depending on their holding period for the option. Sellers receive short-term treatment, without regard to how long they held the option.

Stock options can be entered into by investors who also hold shares in the stock underlying the options. Such options can be subject to various tax rules discussed in Taxation of Derivatives Held by Investors.

Options on Broad-Based Stock Indexes

Options on broad-based stock indices, like the S&P 500 Index or the Russell 3000, are typically purchased and sold on securities and commodities exchanges. When traded on U.S. exchanges, they are not taxed under the rules set out above for equity options. Rather, such options are treated as “non-equity options” and are taxed as “section 1256 contracts.” Such contracts are taxed under two special rules: the 60/40 rule and the mark-to-market rule.[4] Investors (both short and long positions) receive 60 percent long-term and 40 percent short-term capital gain or loss, without regard to how long they have held the contracts. Under the mark-to-market rule, all gains and losses within the taxable year are reported for that year without regard to whether the positions remain open at year-end or they were closed out prior to the last business day of the year.

Conclusion

The tax rules that apply to stock options can surprise unsuspecting taxpayers. Investors and their advisors need to carefully consider application of the rules discussed in this article.

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