Tax Chaos for Traders in Index Options

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Exchange traded index options are generally treated as Section 1256 contracts, and their value is determined following Treasury regulations. Because the regulations weren't written with index options in mind, however, the valuation can be tricky. This article explains how tax results in 2018 were skewed for some investors, and why there may be more problems in the future if some taxpayers decide to game the system.

What happens when you put a tax person in charge of determining the fair market value (FMV) of an index option, and the experts on option trading defer to that person? *Chaos.* Tens of millions, if not substantially more, of phantom gains and losses are being reported to investors and the IRS via Forms 1099. Even relatively small investors are having millions of dollars of gains reported that never existed, realized or unrealized. Others are having a similar amount of phantom losses reported. Instead of being a zero sum game, this convention creates tax chaos for investors and revenue issues for the federal governments.

First, a bit of background.

Tax Reporting

In recent years, Congress has passed laws increasing the amount of information being reported on Forms 1099 and 1099-B to both investors and the IRS. Interestingly, each of these amendments was scored as a revenue raiser by the Congressional Budget Office. The substantive law was not being changed, but compliance with the law was presumed to increase. Of course, this assumes that the information supplied on the 1099s will be correct.

The Law

Exchange traded index options are generally treated as Section 1256 contracts for federal income tax purposes. These 1256 contracts are marked to

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market at year end. As such, they are treated as sold (closed) as of year end for their FMV. All unrealized gains and losses at year end are recognized for federal income tax purposes. For investors, no other securities are afforded this treatment.

It sounds like this rule should be fairly easy to implement since all of these options are traded on exchanges in the United States. But that's not the case.

An Unhappy Surprise When the Rules Don't Suit the Game

Imagine the surprise that some investors with accounts at TD Ameritrade ("TD") experienced at tax time this year. Their 2018 year-end account statements showed very small unrealized losses in their positions in their 1256 contracts. However, when they received their 1099s from TD, they were shocked to see that the IRS was being told that they had unrealized gains in the contracts in excess of $3 million!

The reason for the disparity was a difference in the methodology used to determine the fair market value of the options as of December 31, 2018. For investors' annual statements, TD used the average of the bid/ask spread of the options on December 31, 2018. This methodology complies with Treasury Regulation Section 20.2031-2(c). For tax purposes, the FMV should be determined by what a willing buyer and willing seller would trade. This is what the bid/ask spread is. TD's methodology for its year-end statements did exactly that and showed an option's "true" FMV as of year end.

Unfortunately, TD retained Gainskeeper to prepare its 1099s, and Gainskeeper didn't follow TD's method. Gainskeeper is a leader in the business of tracking securities transactions and services that many broker/dealers, hedge funds, and other private investors use. If Gainskeeper and TD could create such chaos, imagine what others could do.

In its ultimate wisdom, Gainskeeper decided to use the last traded price of each option to determine its FMV at year end. Gainskeeper followed Treasury Regulation Section 20.2031-2(b). The problem with this regulation section is that it was written with stock in mind. The regulation allows the valuation of the security to be based on the last traded value of the day before the valuation date if the security didn't trade on such date. For stock, a 1 percent–2 percent deviation in price might be acceptable, but due to the inherent leverage in options, even a 1 percent–2 percent change in the underlying price of the security can have a substantial impact on the value of the option. The regulations realize that the use of a prior day's value would be unreasonable so they allow the use of bid/ask spreads on the valuation date in Treasury Regulation Section 20.2031-2(c).

For the investors with the $3 million discrepancy, at least one of the option's last trades was in the middle of November. Even in a trade involving the actively traded S&P 500 options ("SPX"), incredible results occurred using this faulty method for determining the year-end fair market value. One of the positions was a vertical spread in the 30 Sep 19 1400 and 1600 call options. Since the options are cash settled and European style, it would be impossible for the spread to have a value greater than 200. However, since the last day that one of the options traded on was December 24, 2018, and the other was December 28, 2018, the 1099 valued the spread at 285! The year-end statement issued by the same firm valued the spread at only 190. A client who was long the spread would have to pay taxes on $9,500 of phantom income for each spread, and $8,500 more than the client could possibly earn. Even after TD was shown this transaction, the company refused to amend the 1099.

Why the Treasury Should Care

There are obviously incorrect 1099s in circulation for investors who trade 1256 contracts. The aforementioned investors will modify their 1099s when filing their tax returns and avoid paying tax on the $3 million of phantom income. However, since the total gains and losses from options always equals zero, there are other investors who were on the other side of these transactions whose 1099s are showing excess losses of $3 million. Query whether those investors are filing their income tax returns just following their 1099s. If they are, it is highly unlikely that the IRS would ever find the discrepancy. While normally this problem should only be a timing difference, so the Treasury might not be that concerned, the individual investor should be concerned.

While the $3 million will reverse next year, the investor will have to pay approximately $1 million in both federal and state income taxes unnecessarily. However, knowing the methodology Gainskeeper uses for 1099 purposes, a mischievous taxpayer could take advantage of the situation.

Problem #1. The following example is a hypothetical that is definitely not following the law, but that would also be virtually impossible for the IRS to detect. The key to the trade is to enter into a riskless position in 1256 options that normally don't trade anymore because they are so deep in the money no investor would trade them. An example of these would be the 17 Jan 20 NASDAQ 100 ("NDX") put and calls with strike prices of 4,100 and 4,200. The NDX is currently trading at about 7,340. It doesn't make sense to spend over $3,000 per call option and no one is buying the put options. However, there are option spreads called "box" spreads. They are a combination of purchases and sales of puts and calls with identical strike prices. The net result is that the purchaser of the spread is essentially investing cash and will receive a fixed return when the options expire. The seller of the box is essentially borrowing money for a fixed cost over the life of the trade. If the purchaser put in a bid to buy 5,000 of the 17 Jan 20 4,100 calls and 4,200 puts while simultaneously selling the 4,200 calls and 4,100 puts for $49.75 million, the order would be filled almost instantaneously. The seller of the box would be borrowing $49.75 million and paying back $50 million in about 10 months. The cost would be less than a basis point.

Effects of the Trade. In our example, assume the NDX goes up by 10 percent to approximately 8,000 during the year. The true unrealized gain in the transaction should be close to zero because the original purchase price was greater than its FMV. However, if the investor buys one of the 4,200 calls at about $3,800 and sells one put for $0.10 at the end of the year, Gainskeeper will produce a very interesting 1099. The options with the unrealized gains will be reported as having no unrealized gain because their trade was the last trade of the year. However, the trades for just one option will be the last traded price of the year, and they will be used to value the options. Under these assumptions, the 1099 will show a phantom loss of approximately $344 million. Even the Treasury could get excited about that.

Problem #2. Another interesting effect could be engineered for traders who otherwise just earn short-term capital gains. Assume a trader earns $10 million of short-term gains. The trader would pay approximately $4.08 million of federal income tax—37 percent of regular tax and 3.8 percent of net investment income tax. The trader could enter into the aforementioned trade that produces $10 million of 1099 losses this year and $10 million of 1099 gains next year. Instead of doing $20 million next year, and just increasing the size of the trade by $10 million each year like the traders of straddles in Chicago did in the 1970s or the bankers and dealers in New York did in T-bill trades during the same period, our taxpayer will pay the tax in year 2. However, the total $10 million of gain will come back as $6 million of long-term gain and $4 million as short-term gain. As a result, our hypothetical trader's tax bill will be decreased from $4.08 million to $3.06 million, for a permanent tax saving of $1.02 million (17 percent of $6 million).

Could it Be Any Worse? Yes. For short positions of stock, gains and losses are reported on 1099s in the year the transaction is closed. Short positions are treated as closed when the borrowed stock is returned to the lender. Since the short seller can't return the stock until the stock is received, the closing transaction is reported in 2019 even though the short seller bought back the stock on December 31, 2018, to close the short sale. Absent the application of Internal Revenue Code Section 1259, the constructive sale rules, that is the proper tax result. The short sale is not closed for tax purposes until the delivery is made in January 2019. Gainskeeper applies the same rule to 1256 options. That would be okay if Gainskeeper treated the gain/loss on the short option as unrealized, and reported the gain/loss as an unrealized gain/loss on the 1099. However, Gainskeeper completely ignores the short option for 1099 reporting in the first year and just reports the gain/loss in the second as if it were a non-1256 option or stock.

Once again, a mischievous taxpayer could try to take advantage of the faulty 1099 reporting. Again a large box spread could be entered into. This time the box spread would use options that are close to the value of the index (“at the money”). At the end of the year, either the short call or the short put will have an unrealized gain. The taxpayer would close out the position and simultaneously enter into another short option with a different strike price to maintain the economic integrity of the position. Voila! The gain has just been eliminated from the current year leaving the taxpayer with a loss per the 1099.

Conclusion

In summary, 1099s have become extremely important. Taxpayers and their tax preparers rely on them to prepare tax returns, and the government has built a sophisticated computer system to match 1099s that it receives to the taxpayer’s individual tax return. As long as they match, everyone is satisfied. Perversely, if a taxpayer corrects one of these incorrect 1099s, the IRS will automatically send out a deficiency notice because the 1099s don’t match the tax return. If the taxpayer includes the 1099 number on his or her tax return, and then makes an adjustment, the 1099s will match the return, but there would be a very good chance the return will be audited.

The only person happy with this situation is the mythical mischievous taxpayer. I believe that the mischievous taxpayer may not be mythical at all.