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What Could Be Wrong in Your 1099s?

The government thought that a lot of revenue was being lost because there was no mechanism for the IRS to know if a taxpayer sold a position that was a taxable event. The first phase was to create a burden on the brokers to be the policeman and report when clients sell stock. Once that was in place, the IRS could scrutinize tax returns to see if those taxable events were reported or not.

The problem was that not all sales are taxable events and some clients then had the problem of the IRS not finding a matching transaction on their tax return that could then trigger an audit. Taxpayers were told to attach a letter of explanation that a short sale they made was the beginning of a trade not the end of a trade that needed reporting. This also would happen if the client had a wash sale.

Well years went by and the government wanted more; they wanted the brokers to actually report the gains and losses that the clients triggered during the year. How could a broker know a client's cost basis unless the shares were bought at that firm? What if the shares were bought years ago? The brokers cried foul and were able to get the rules to phase in over time; the last implementation phases are rippling through the system this tax season.

Brokers now must report cost basis, gain or loss on equities, options and most bonds purchased after a specified date. If an account is transferred that information must be passed on to the next brokerage firm. But don't think that the 1099 report of realized gains/losses is like your W-2 that you just hand over to your accountant. **THE 1099 IS BUT A STARTING POINT OF ISSUES THAT NEED LOOKING INTO.**

Yes you will get a statement of the gains/losses of stocks purchased after Jan. 1, 2011- but you must remember that it will not include any gains/losses from stocks bought before that date. The broker report is not a complete tax accounting of what happened in an account. Brokers only started keeping track of options and bonds for 2014 trades and those are the 1099s that everyone just received.

Brokers also were charged with policing and reporting of wash sales. This task was more complicated than first contemplated because the wash sale rules are quite complicated. It is easy for a broker to "catch" a wash sale when one sells a share for a loss and then buys it again in the same account within 31 days. A wash sale occurs when a loss position is replaced by a "substantially identical" position. If you sell a stock and then buy a call on that stock it is a wash sale but it will not be reported. That doesn't mean it wasn't a wash sale that you and your accountant should be aware of. Likewise if you sell in your "regular" taxable account and repurchase in your IRA; again no wash

sale reporting even though the government issued a ruling that is a wash sale. Brokers don't even report if the repurchase is done in a second account at the same broker. The taxpayer is tasked with applying the rules with a few good hints from the broker.

Sometimes these inaccuracies, if ignored, could work to the client's benefit. President Bush lowered the tax on "qualifying" dividends to about half the tax rate on non-qualifying dividends. Brokers were tasked to report to their clients whether the dividend they received was a "qualifying" dividend. A "qualifying" dividend is one that is paid out of corporate profits that have been taxed at the corporate level (paid out of earnings and profits- E&P). In order for a client to get the tax benefit afforded "qualifying" dividends not only does the dividend have to come out of E&P; the client has to hold the stock (unhedged) for 61 days. Brokers are not responsible for looking at this aspect and thus report any "qualifying" dividend paid by a company as a "qualifying" dividend whether the client held the stock for one day (the record date) or for 61 days.

This tax season was particularly vexing with option reporting being phased in as of Jan. 1, 2014. There are different tax regimes for options that trade on an exchange and options that trade OTC. All exchange traded options on single stocks and almost all OTC options (on anything) are taxed "normally", if held for less than 1 year triggering short term gain or loss -if held for more than 1 year long term gain or loss. Note that all written options will always be short term.

However, exchange traded options on anything other than an equity are taxed under Section 1256. These options are taxed as being 60% long term and 40% short term whether the options are held long or sold short and no matter how long they are held. Additionally these options are marked-to-market at every year end. You may recognize this as the tax treatment offered exchange traded futures. Indeed it was the introduction of S&P 500 index options that spawned this unique option tax treatment.

The problem is the brokers either couldn't or didn't want to try to identify which options should get what tax treatment. Many ETFs are not equities, for that matter they are not funds either. As an example, GLD is a grantor trust holding gold- clearly that is a non-equity. However the brokers are not reporting options on GLD as an option that should get 1256 treatment. An investor who bought an exchange traded option on GLD and held it over year end will see nothing in their 1099 about that holding. The report should have marked the position to market at year end with the resulting gain or loss being reported as 60% long term/40% short term. Instead the taxpayer will need to attach a note onto their return to explain the situation and do the taxes properly. This will be the case for exchange traded options on many ETFs, MLPs and other broad based indexes like the S&P.

You might empathize with the broker's dilemma of divining which is which when you recognize that an exchange traded option on the S&P 500 ETF (an actual equity) is taxed normally and an exchange traded option on the S&P 500 index is taxed as a Section 1256 contract. Brokers have been told to give it their best shot but are expressly forgiven if the information is incorrect. If they can't figure it out how are our client's supposed to?