United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-261140

May 5, 1995

The Honorable Bob Franks
House of Representatives

Dear Mr. Franks:

This letter responds to questions you raised in your letter of March 21, 1995, about the possible reporting of options transactions to the Internal Revenue Service (IRS) on information returns.[1] An option is a contract that gives the purchaser the right, in exchange for a premium, to buy or sell a specific amount of a property at an agreed upon price by a specified date (enclosure 1 has more information on options).

You asked us to discuss IRS' reasons for not requiring information reporting on options and issues to be considered in reporting and using such information. You also asked how much tax revenue could be generated under information reporting for options. This letter provides descriptive responses to your questions and more details in enclosures. Our responses note relevant considerations but do not address whether an effective information reporting program for options is feasible. We did not attempt, in the limited time we had, to analyze all information received from IRS and industry groups. For example, IRS officials told us that administrative obstacles would challenge the feasibility of reporting and using options information. They believed IRS first needed to study whether a compliance problem exists and whether the obstacles could be addressed.

[1]Third parties such as banks and brokers file information returns with IRS and taxpayers to report payments such as interest and gross proceeds from stock sales. Enclosure 2 describes such reporting for investment transactions such as stock sales.

~~063534/~~ 154201

To answer the questions on why options information reporting was not established and issues that could affect the reporting and use of the information, we interviewed IRS officials in the Office of Chief Counsel; Service Center Compliance Team and Financial Products and Transactions Office. We reviewed IRS data on information reporting on transactions such as stock sales and futures contracts.[2] We also reviewed data from the Securities and Exchange Commission (SEC), and discussed the questions with industry groups such as the Securities Industry Association (SIA), Futures Industry Association (FIA), Chicago Mercantile Exchange, and Chicago Board of Options Exchange (CBOE). Further, we attempted to locate data, such as on compliance in reporting option income, that would be needed to estimate the potential revenue impact of information reporting on options.

ISSUES IN REPORTING OPTIONS ON INFORMATION RETURNS

Under section 6045 of the Internal Revenue Code, the Secretary of the Treasury has broad authority to subject investment payments to information reporting. Using this authority, the Secretary has required information reporting on trading of securities and commodities. And except for futures contracts, the information reported is the gross proceeds of sales not the capital gain or loss.

The Secretary has not required information reporting on options due to obstacles raised by the relatively complex nature of these transactions. IRS officials said that such a reporting program could entail administrative difficulties and reporting burdens which might outweigh its benefits. They noted that the program might be justified despite these obstacles and burdens, given sufficient underreporting of options income. However, IRS has not measured the extent of such taxpayer noncompliance involving options income.

In 1990, IRS Chief Counsel started a project to establish regulations for information reporting on options. Chief Counsel officials said options complexities and lack of compliance data slowed the project, which is now inactive. They said that complexities, such as tracking the delayed tax consequences of certain options transactions, confounded efforts to draft specific rules on options reporting.

Industry representatives we interviewed pointed to similar complexities in reporting options transactions. They also said

---

[2]Futures contracts obligate the holder to buy or sell a specific item at a specific price, quantity, and date in the future.

that such a reporting requirement would impose additional costs on their members. Our discussions with these representatives indicated that many brokers annually report options transactions to clients, and other periodic reporting to clients is mandated by industry associations and Federal regulators. We did not find data to show whether or how readily such information could be used to improve tax compliance. Enclosure 3 discusses existing information reporting under Section 6045, IRS' regulation project, examples of reporting obstacles, and options transactions that could be most amenable to reporting.

ISSUES IN COMPUTER MATCHING OPTIONS INFORMATION RETURNS

Complexities stemming from the nature of options transactions could limit IRS' uses of reported information. IRS' basic use of existing reported information involves computer matching dollar amounts reported on the information returns and on the tax returns to identify unreported income. IRS staff attempt to resolve selected discrepancies by reviewing the documents, and may contact taxpayers for an explanation or a tax payment if the discrepancy remains unexplained. Reports we have issued over the years show that even if IRS cannot fully match or otherwise use the information, it still helps taxpayers to voluntarily comply and may induce them to comply if they know IRS also receives the information.

An effective computer matching program relies on clear criteria for matching information return amounts to lines on tax return documents. IRS officials discussed factors that could complicate the development of criteria for cost-effective matching. For example, IRS officials said IRS may need to revise tax return forms and transcribe more lines into the computer. Also, they questioned how well the reported information could be used to identify actual noncompliance rather than false leads. Although such problems already exist for stock and some other transactions, the officials believed that matching options information could generate more false leads due to differences in where and when certain options transactions would be reported on tax returns as opposed to information returns. If the options information could not be effectively matched, IRS officials said it could be used in auditing tax returns. However, IRS audits about 1 percent of all individual returns.

Enclosure 4 discusses issues in computer matching reported options information. It describes potential challenges and opportunities for matching within the context of other types of information returns under section 6045 that IRS already uses.

OTHER ISSUES TO CONSIDER IN REPORTING AND MATCHING OPTIONS

IRS officials have not determined the cost-effectiveness of reporting and computer matching options information. Nor have they analyzed whether reporting burdens on third parties would be justified. In assessing information reporting for options, these and other issues would need to be considered. For example, the extent of tax noncompliance involving options income and existing broker reporting to customers would be relevant considerations. If information reporting is deemed to be desirable, IRS would need to address obstacles to the effective reporting and matching of options information.

Another issue involves the regulatory exemption under section 6045 on reporting payments made to corporate, financial, and other institutions.[3] An official at the CBOE estimated that slightly more than half of their options transactions involved institutions instead of individuals. Similarly, the portion of stocks owned by institutions has grown from 30 percent to over 50 percent since the mid-1970s according to SEC data. Therefore, an options reporting program initiated under this Section 6045 exemption would omit a sizable segment of the options market. In 1991, we reported on the costs and benefits of information reporting on payments made to corporations as well as ways to overcome certain reporting barriers.[4] Our analysis included capital gains income generally but did not discuss options.

MORE DATA NEEDED TO ESTIMATE REVENUE IMPACT

Data that could be used to estimate tax revenue from information reporting on options were not readily available. In addition to data on the volume of options transactions, it would be necessary to know the extent of taxpayer compliance in reporting options income. Also, IRS would need to decide on how options information would be reported and used in order to estimate impacts on compliance and revenue.

We made a draft of this letter available to the IRS Commissioner and received comments from IRS' Chief Counsel for Financial Institutions and Products, the executive in charge of information

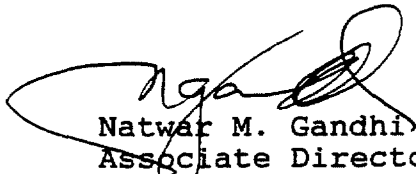
---

[3]According to a 1991 IRS study, the corporate exemption arose from concerns that the costs and burdens of a corporate information program would outweigh the potential compliance improvement.

[4]Tax Administration: Benefits of a Corporate Document Matching Program Exceed the Costs, (GAO/GGD-91-118, Sept. 27, 1991).

reporting, and the Chief of Staff for the Assistant Commissioner for Examination on April 21, 1995. They generally agreed with the accuracy of the information in the draft. We incorporated their suggested technical changes where appropriate. We hope this information meets your needs. If you have any questions concerning this letter, please call me on (202) 512-9044.

Sincerely yours,



Natwar M. Gandhi
Associate Director, Tax Policy
and Administration Issues

DESCRIPTION OF TYPES OF OPTIONS AND THEIR TAX TREATMENTS

WHAT ARE OPTIONS?

An option is a contract that gives the holder the right to enter into a transaction to buy or sell a specific amount of an underlying property at a fixed price by a specific date. Some options involve equities (e.g, stocks). Other options involve nonequities such as futures contracts, interest rates (debt options), stock indices, or foreign currencies. Options may be purchased or sold through exchanges (i.e., listed) or over the counter.

According to FIA and CBOE data, 314 million options contracts were traded on U.S. exchanges in 1993. Of the 314 million contracts, stock options accounted for 132 million, futures options for 82 million, stock index options for 87 million, and debt and foreign currency options for the remaining 13 million. A CBOE official (where about 60 percent of the stock and stock index options were traded in 1993) estimated that slightly more than half of their traded options contracts involved institutional customers like banks and securities firms and the rest involved individual customers.

Options to buy property are known as calls while options to sell are known as puts. An example of a call option for a stock would be one granting the option holder (the person buying) the right to buy 100 shares of a company for $80 per share (the strike price) by October 21, 1995 (the expiration date), regardless of the market price of the stock when purchased. Similarly, a put option would grant the holder the right to sell 100 shares of a company at $80 a share by October 21, 1995. Stock options are available through exchanges for various strike prices and expiration dates.

OPENING AND CLOSING TRANSACTIONS

Opening a position takes place when an option is first bought or sold for its market price or premium. At this stage, option buyers pay the premium for put or call options and option sellers (grantors) receive the premium. Options traded through exchanges are processed through a clearinghouse. Option holders can close their positions through either (1) exercise, (2) expiration, or (3) an offsetting transaction, as described below.

-- An option is exercised when the holder buys or sells the underlying property at the strike price. For example, the holder of a call option on a stock with a strike price of $60 per share might exercise the option when the stock reaches $70. The options clearinghouse would process this exercise, and the grantor assigned the exercise would be required to sell the stock at $60 per share.

-- Expiration occurs when an unexercised option reaches its expiration date. An option might be allowed to expire because the anticipated market movement failed to materialize.

-- An offsetting transaction is a sale or purchase of the same option contract previously bought or sold; if the opening transaction is a buy, the offset is a sell and if the opening is a sell, the offset is a buy. An offsetting transaction allows the option (1) holder to profit from price movements without buying the underlying property and (2) grantor to lock in a gain or loss or to close out a losing position.

TAX TREATMENT OF OPTIONS TRANSACTIONS

Prior to the Tax Reform Act of 1984, all option transactions were taxed under a completed transaction approach; that is, gains and losses were not taxed until the option expired or was exercised. At that time, the taxpayer would account for the premium paid or received. By exercising the option on underlying property, no gain or loss would occur on this transaction and the property's basis would be adjusted by the amount of the option premium. A taxable event would not occur until the underlying property itself was later bought or sold.

The 1984 Act continued this tax treatment but added a second one for some options as discussed below. In part, Congress made these changes because it was concerned that taxpayers were exploiting the rules and deferring tax on unrelated transactions by using options straddles to recognize a loss on one option while holding the offsetting option that had an unrecognized gain.[5] In addition, Congress wanted to provide uniform tax treatment for competing option products traded on different exchanges.

After the 1984 Act, the tax treatment of exchange-listed options depended on whether the (1) option was an equity or non-equity

---

[5]Options straddles are offsetting options positions whose market values vary inversely.

option and (2) holder of an equity option was a dealer. An equity option is an option on a stock or narrow stock index (e.g., selected computer stocks).

The first tax treatment continued the completed transaction approach for equity options held by an investor or speculator (i.e., someone who is not an options dealer or market maker). Table 1.1 displays the general tax treatment of such equity options.

Table 1.1 Taxation of Exchange Listed Non-Dealer Equity Options

Opening Position	Tax effect by type of closing transaction		
	Expiration	Offset	Exercise
Call purchased	Premium paid is loss	Premium paid less premium received is gain or loss	No option gain/loss recognized. Premium paid is added to tax basis.
Call sold (granted)	Premium received is gain	Premium received less premium paid is gain or loss	No option gain/loss recognized. Premium received is added to sales proceeds.
Put purchased	Premium paid is loss	Premium paid less premium received is gain or loss	No option gain/loss recognized. Premium paid is deducted from sales proceeds.
Put sold (granted)	Premium received is gain	Premium received less premium paid is gain or loss	No option gain/loss recognized. Premium received is deducted from tax basis.

Source: IRS

Table 1.1 does not address the taxation of all transactions for these equity options. For example, equity options that are part of straddle positions are subject to the loss deferral rules of Code section 1092. Under these rules, taxpayers can deduct realized losses from closing a position to the extent that the losses exceed unrealized gains from an offsetting position. A loss disallowed under this rule is carried over to the succeeding year.

The 1984 Act added a second tax treatment for (1) equity options held by dealers or market makers and (2) non-equity options.

These options are taxed under the provisions of Code section 1256.[6]

Under section 1256, the taxable gain or loss for a year is the sum of the realized gain or loss from closed option positions adjusted for the change in the unrealized gain or loss for option contracts that were open at the beginning or end of the year. The unrealized gain is determined by marking the open options to market (i.e., the market price at year's end). The net section 1256 gain or loss is considered to be 60 percent long-term and 40 percent short-term.

---

[6]Regulated futures contracts are also taxed under the provisions of Code section 1256, and net section 1256 gain or loss consists of results from both options and regulated futures transactions.

LEGAL AND REGULATORY REQUIREMENTS FOR INFORMATION REPORTING BY BROKERS

Information reporting of broker transactions is governed by Code section 6045 and related regulations. Between 1954 and 1983, the Secretary of the Treasury did not use the authority under section 6045 to require brokers to report customers' gains and losses. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) amended section 6045 to (1) allow brokers to report gross sale proceeds rather than gains or losses and (2) require brokers to provide customers with the information they report to IRS.

Congress amended the section because it was concerned about the low tax compliance for capital gains, which IRS estimated to be below 60 percent for 1981. IRS officials said that gross proceeds were easier to report than gains or losses, which require knowledge of the cost basis of the security or commodity.

Congress expected the Secretary to issue regulations that would conform broker information reporting to industry practices in maintaining records. The regulations required brokers to file information returns on (1) sales (including short sales) of securities and commodities, (2) closing transactions in forward contracts, and (3) unrealized proceeds from marking regulated futures contracts to market at year's end.

The regulations did not require information reporting for options transactions. IRS Chief Counsel officials said IRS did not believe that the regulations could effectively address the complexity of options transactions at that time. According to the preamble of the 1982 proposed regulations, IRS planned to open a regulation project on information reporting for options. As discussed in enclosure 3, IRS did not open this project until 1990, and it is now inactive.

Nor did the regulations require information reporting when the customers (e.g., corporations) qualified for exemption from withholding on interest and dividends.[7] According to Chief Counsel officials, the TEFRA provisions focused on reducing noncompliance by individuals. The 1982 proposed regulation preamble also cited IRS plans to study whether more customers should be subject to broker information reporting. IRS Chief Counsel officials were unable to tell us whether the study was ever conducted.

---

[7]TEFRA established tax withholding on payments of dividends and interest to individuals and unincorporated entities. The act, which exempted payments to corporations (among other recipient categories), was repealed in 1983.

INFORMATION REPORTING ISSUES FOR OPTIONS TRANSACTIONS

EXISTING BROKER INFORMATION REPORTING

Brokers are generally required, under section 6045, to annually report sales or redemptions (including short sales) of securities (e.g., stocks, mutual funds, bonds), commodities, foreign currency contracts, forward contracts, and regulated futures contracts to IRS and the customer on Form 1099-B. This information return should report each transaction, except for regulated futures and foreign currency contracts. Information returns are to report the (1) recipient's name and tax identification number, (2) security or property sold, (3) date of sale, and (4) gross sales proceeds. The returns must be sent to the taxpayer by the end of January and to IRS by the end of February.

Separate transaction reporting is not required for regulated futures contracts taxed under section 1256. Instead, brokers are to report, in addition to information about the recipient, the net gain or loss realized from contracts closed during the year, net unrealized gain on open contracts at the beginning and end of the year, and the aggregate gain or loss for the year.

IRS' OPTIONS REPORTING REGULATION PROJECT

IRS started a project in 1990 to look at the possibility of developing information reporting for options. As of April 1995, IRS officials said the project is inactive, and the benefits of an options information reporting program may not be worth the administrative and taxpayer burden. These officials pointed to two major challenges in using any reported options information. Enclosure 4 discusses these and other challenges to using the information, but the following summarizes the two challenges mentioned by Chief Counsel officials.

- IRS did not have the computer capability in 1990 to fully use information returns on options and still may not have enough capacity to justify the additional reporting burdens.

- Timing differences may make gross proceeds reporting on options less useful compared to other broker transactions. For example, options premiums received in 1 year may not be taxable until a future year or may only be used to adjust the basis of the underlying property.

IRS has not analyzed whether options reporting would increase taxpayer compliance and whether the benefits from any increase would outweigh IRS' costs, and the reporting burdens. Chief Counsel officials said this question would not have to be addressed until IRS has the required computer capability.

BROKERS MAINTAIN DATA ON OPTIONS TRANSACTIONS

If developed, the regulations on information reporting for broker transactions were expected to conform reporting requirements to industry practices in maintaining records. The following describes existing broker practices for reporting options transactions to their customers. These practices may provide insight on options information that brokers would be most able to report to IRS.

Rules promulgated by the National Association of Securities Dealers govern the activities of member brokers. For options, member brokers are required to provide each customer (1) written confirmation of each transaction and the related details and (2) periodic account statements. Statements are to be sent monthly to customers with options transactions during the month and no less than quarterly to those with open options positions. Statements should show option positions in the account, activity during the period, and for customers with margin accounts, the mark-to-market price and market value of each option position.

Similarly, CFTC also requires reporting on options transactions. CFTC rules generally require commodity brokers to provide written confirmation of each option transaction and monthly statements to customers who entered into options transactions or had open options positions. The statements must include detailed options information on the (1) transactions, (2) premiums, (3) realized profits and losses, and (4) marked-to-market value of open commodity or foreign option positions.

On the surface, it appears that various options transactions that brokers report to customers could be readily reported to IRS. For example, stock options bought and sold without being exercised generate premiums that apparently could be reported on information returns much as gross proceeds are reported for stock sales. Similarly, net capital gains or losses on nonequity options apparently could be reported much like they are for regulated futures contracts. However, the overall benefits, costs and payor burdens of options reporting are not known. The next section discusses some reporting difficulties discussed by IRS and industry groups.

REPORTING DIFFICULTIES FOR OPTIONS TRANSACTIONS

Although brokers and dealers are already required to report some options information to their customers, the burden of reporting options information to IRS has not been measured. It is unclear how significantly brokers would need to modify their current customer reporting systems to report this information to IRS.

For example, an informal survey taken by a CBOE official indicated that problems in determining opening and closing trades would hamper brokers in reporting completed options transactions. Some brokers already identify all options transactions during the year for their customers but may not identify them as opening and closing trades. A Chicago Mercantile Exchange official said its member firms would incur significant costs if they were required to collect and report options purchases and sales for a year. We identified no studies on whether options reporting would generate such significant costs for most brokers.

Regardless, expanding information reporting to cover options transactions would impose at least some additional costs on brokers. These costs would involve (1) programming computers to collect, maintain, and report the required tax information, and (2) printing and sending the information returns to customers and IRS.

ISSUES IN COMPUTER MATCHING REPORTED OPTIONS INFORMATION

IRS computer matches corresponding data reported on information and tax returns for specific taxpayers. The match attempts to identify income not reported on tax returns. IRS attempts to pursue discrepancies depending on available resources and the associated revenue or refund potential. If the computer match produces a false lead, IRS may waste resources and burden taxpayers in pursuing discrepancies. False leads arise from problems with the matching criteria and process.

The following discusses existing computer matches of information returns from brokers and issues to consider if IRS were to match options information.

EXISTING COMPUTER MATCHING FOR BROKER INFORMATION

IRS matches information reported by brokers on Form 1099-B. The information reported under section 6045 includes gross proceeds from the sale of financial assets such as stock, bonds, and mutual funds, and net gains or losses from regulated futures transactions. For tax year 1992, IRS received 72 million forms 1099-B and identified 1.9 million discrepancies through computer matching.

IRS officials said false leads from discrepancies involving gross proceeds reported on Form 1099-B arise for various reasons. For example, all data needed for effective matching are not transcribed into IRS' computers. Also, inconsistencies in how brokers and taxpayers report sales commissions (e.g., reporting sales net of commissions) can create false leads. Further, having only gross proceeds information, IRS cannot verify any unreported capital gain income without contacting the taxpayer for documentation on the investment's cost basis.

Limitations in the data that IRS transcribes into its information return and tax return databases also impede computer matching for futures contracts. However, the futures information reported on Form 1099-B identifies net gains and losses, eliminating the need to obtain cost-basis data from taxpayers. Taxpayers are to report futures contract information on Form 6781 (i.e., tax return attachment on gains and losses from futures contracts and straddles).

OBSTACLES TO EFFECTIVE COMPUTER MATCHING OF OPTIONS INFORMATION

These current obstacles from information discrepancies and limitations also could hamper computer matching of options information. For example, if a gross-proceeds rule were applied to equity options, the lack of cost-basis information would likely complicate IRS matching. Other complications could emerge, depending on the information reporting rule adopted for options. We found no IRS data to indicate whether matching for options would produce more false leads than matching for Form 1099-B information. But our discussions with IRS officials suggested issues to consider in computer matching of options transactions, as summarized below for both equity and nonequity options.

Matching equity option information

Equity options granted and closed in different tax years could result in false leads if reported under the gross proceeds rule. CBOE data for 1993 indicated that about 10 percent of the equity option contracts granted through CBOE closed in a future year. In such cases, the option grantor's premium would be reportable on an information return for that year but not reportable on the tax return until the year of the closing transaction.

Even if the option is granted and exercised in the same year, the option grantor's premium may be difficult to match. For example, the grantor of a call option should add the premium to the proceeds received upon the sale of the underlying property. In this case, the premium is not separately identified on the tax return. SEC data show that about 10 percent of the equity option contracts traded in 1991 were exercised.

Matching nonequity options information

Nonequity options are subject to the same mark-to-market tax rules as those applied to regulated futures contracts. Futures contracts are already subject to information reporting on net gains or losses, including those for positions remaining open at year's end. These gains and losses are to be reported in a separate section of Form 1099-B. As a result, the computer matching issues for these regulated futures contracts would likely be similar to those for nonequity options.

Our work has not uncovered any aspects of nonequity options trading that would raise different obstacles than those already existing in matching futures information. For example, both nonequity options and futures contracts can be traded as part of

mixed straddle positions[8]. IRS officials acknowledged this similarity but said they needed more time to analyze issues in matching nonequity options.

(268688)

[8]A mixed straddle involves a section 1256 contract and an offsetting holding not subject to these rules.

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20884-6015

or visit:

Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000
or by using fax number (301) 258-4066, or TDD (301) 413-0006.

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (301) 258-4097 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

United States
General Accounting Office
Washington, D.C. 20548-0001

Bulk Mail
Postage & Fees Paid
GAO
Permit No. G100

Official Business
Penalty for Private Use $300

Address Correction Requested