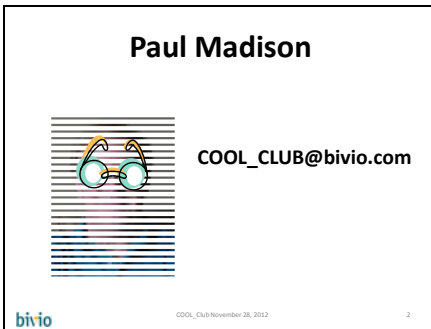


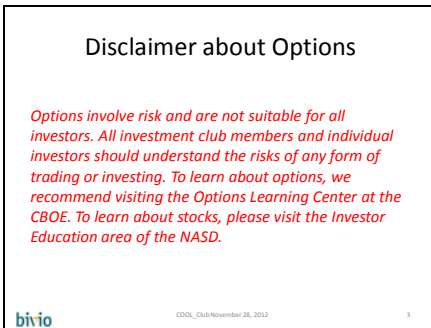


Good evening and welcome to the Covered Options Online Learning Club otherwise known as COOL_Club.

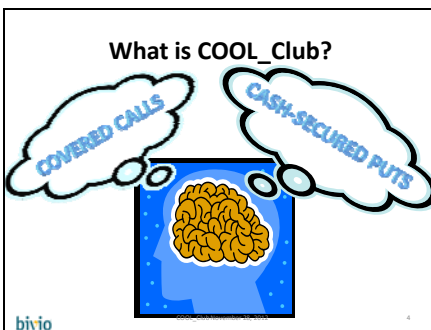


I am Paul Madison and I am your host for the COOL_Club

You can write to me at the COOL_Club discussion list which is COOL_CLUB@bivio.com



Quick disclaimer that Options do involve risk and may not be suitable for all investors. I encourage you to learn more about options and stocks and the slide mentions a couple of resources for additional education.



COOL_Club is a weekly 30 minute session where we explore the thought processes associated with actual Covered Option Trades.

Most sessions we will walk through one or two trades from the recent past.

Going through the logic on why we are looking at a particular option on a particular stock.

We will look at both when trades are put on and we will come back and look again at them when they are closed.

Some nights, like tonight, we will cover special topics.

November Schedule

- First Wednesday (Nov 7th) 5 pm ET
Selling Covered Options – Index ETF
- Second Wednesday (Nov 14th) 9 pm ET
Selling Cash Secured PUTs
- Third Wednesday (Nov 21st) Break
Thanksgiving Week
- Fourth Wednesday (Nov 28th) 9 pm ET
Covered Options & Taxes

bivio

COOL_Club November 26, 2012

5

We find ourselves at the end of the November Schedule and we will be talking about Covered Options & Taxes.

December Schedule

- First Wednesday (Dec 5th) 5 pm ET
Selling Covered CALLS
- Second Wednesday (Dec 12th) 9 pm ET
Selling Covered Options – Index ETF
- Holiday Break (Dec 19- Jan 2)

bivio

COOL_Club November 26, 2012

6

We will only do two sessions in December the 5th and 12th and note that the second week time is at 9pm Eastern.

We will take a bit of an extended break for the last part of December and the first week in January. We will return to business on January 9th. Topic and time to be announced.

COOL_Club Home Page

COOL_Club Home Page

COVERED CALLS
CASH SECURED PUTS
COVERED CALLS AND CASH SECURED PUTS

RESOURCES AND TOOLS
PRESENTATIONS
MEETING DATES AND TIMES

Status of COOL Club Sample Trades

www.bivio.com/COOL_Club

bivio

www.bivio.com/COOL_Club

7

Here is our COOL_Club home page

The link is www.bivio.com/COOL_Club

Both Handouts and recordings are under the Presentations link

Join the email discussion list by clicking here

You can get to the Excel COOL TOOL spreadsheets by clicking on "Resources and Tools"

And finally the schedule and registration links are here.



bivio


COOL_Club November 26, 2012

8

Tonight we are going to talk a little about covered options and taxes.

We will cover both the normal covered option scenarios but also a few not normal situations to help you better understand how covered options might affect your taxes.

IRA's




- Great place to do covered options!
- No short term tax consequences

bivio COOL_Club November 28, 2012 9

Before we get into Taxes, let me take just a second to remind you that I love doing covered options in IRAs. Covered options are the only type of options that the government will allow you to do in IRAs. I assume that is because they believe they are relatively low risk. If you stick to doing covered options in your IRA then there will be no short term tax consequences to worry about.

Well almost none, there is one caveat to this that we will discuss under the special scenarios.

Capital Gains



- Long Term Capital Gains
 - Stocks held longer than 1 year
 - Current Long Term Capital Gain Tax Max 15%
- Short Term Capital Gains
 - Stocks held shorter than 1 year
 - Taxed as “Ordinary” Income


bivio COOL_Club November 28, 2012 10

One more housekeeping item. We will be talking about Short and Long Term Capital Gains and I thought we would just take a second to remind us what that means.

If you own a stock for one year or longer, then when you sell it your gains will qualify for the long term capital gains tax rate which currently tops out at 15%. As you may be aware, this will go up next year unless Congress does something before the end of the year.

If you own a stock for less than one year and sell it, the gains (or losses) will be subject to ordinary income tax and will be taxed at your incremental tax rate.

Taxable Accounts (& Clubs)



- Covered Option Normal Scenarios:
 - STO → Expired worthless
 - STO → Exercised
 - STO → Then BTC, made money
- Special Scenarios

bivio COOL_Club November 28, 2012 11

So now let's move to doing covered options in taxable accounts which includes, of course, investment clubs.

We have three normal scenarios that we will explore and then as I said we will talk about a couple special scenarios you need to be aware of.

Expired Worthless



- For both **CALLS** and **PUTS**
 - First **Sell-To-Open**
 - The option expires worthless
 - The premium collected net of commissions is a short term gain
 - Short term gains are considered "Ordinary" Income
 - Taxed at your incremental income tax rate

bivio

COOL_Club November 28, 2012

12

Let's start with our simplest.

If you Sell-To-Open a Covered Call or Cash Secured Put and hold it to expiration

and it expires worthless.

Then the premium you collected net of commissions when you sold the option is viewed as a short term capital gain.

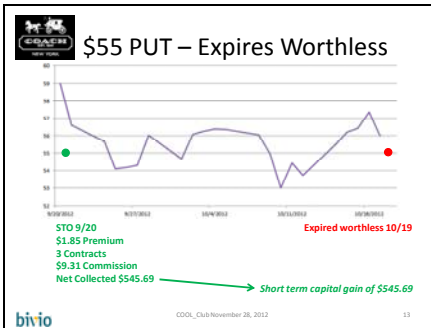
Remember short term gains are considered "Ordinary" Income and so will be taxed at your incremental income tax rate.

Here is an example.

Sold a Coach \$55 Put on September 20 at a \$1.85 premium. Three contracts were sold and there was a little over \$9 commission. Net Collected was just over \$545.

On October 19th that option expired worthless as Coach was above \$55.

The entire \$545.69 would be considered a short term capital gain.



Covered Call - Exercised



- Your stock is sold at the strike price
- Your sales price
= Strike price + Premium collected – Commissions
- Treated just like a normal sale of stock
- Long or short term capital gain/loss?
– Based on date you bought the underlying security

Next let's consider the scenario that on the expiration date the option is in the money and so your option (not you) is exercised (this scenario would also be true if you were called away early).

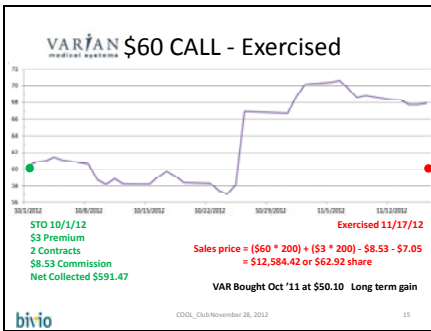
For a call option, this means that your stock is sold at the strike price.

All we have to do is determine what our effective sales price is.

It is the Strike price + premium collected – commissions on the option as well as any trade commissions or assignment fees that might be charged.

Once we know our sales price, the stock sale is treated just like a normal stock sale.

This means that the determination of whether you have a long or short term gain will be driven by when the stock was purchased to begin with. If you have held it for more than a year it will be a long term gain and less than a year, it will be a short term gain.



Here is an example of a Covered Call that was exercised.


On October 1st we sold November VAR \$60 Calls that were right at the money. Collected \$3 premium on two contracts and paid \$8.53 in commissions. Net collected was \$591 and change.

By the way this was breaking the golden rule because I was selling across an earnings date. But I had a nice profit in the VAR position and was worried about losing a good portion of that if the earnings were not good.

On expiration date VAR was around \$68 and so I was exercised.

My sales price would be the Strike price of \$60 times the shares plus the \$3 premium collected times the shares less the commission on the option sale as well as the commission on my stock being sold. If your broker has an assignment fee you would be able to subtract that as well. So I was called away at just under \$63/share.

For me this was a long term capital gain as the Varian position had been bought in October of 2011 at just over \$50.

Cash Secured PUT - Exercised 

- You buy the security at the strike price
- Your basis (purchase price)
= Strike - Premium collected + Commissions
- Treated just like a normal purchase of stock
- Long or short term capital gain/loss?
– Based on future date when you sell the underlying security

bivio CDOO_Chub November 28, 2012 15

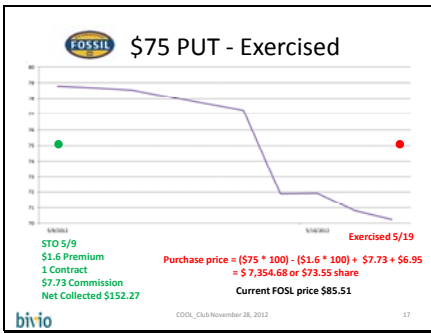
Now let's talk about a Cash Secured Put that is Exercised.

You will buy the security at the strike price

and your purchase price or basis will be the Strike less the PUT premium collected plus the commissions on the options as well as any trade or assignment fees.

At this point the option gets rolled into the underlying security position and is treated as a normal stock purchase,

You will not know whether it is a long or short term gain until at some point in the future when you sell the security.



Here is an example of a \$75 Cash-Secured PUT on FOSL.

The option was Sold-To-Open on May 9th at \$1.60 premium for 1 contract.

Ten days later the stock closed below the \$75 level and so I bought 100 shares of FOSL.

My purchase price was the Strike price – the put premium collected + the commissions paid on the option as well as the commission paid on the purchase of the stock.

So my net cost per share is \$73.55 and six months on FOSL is at \$85.51/share.

The shares would have to be held past May 19th, 2012 to qualify for long term capital gains.

BTC – Made Money

- Majority of my trades
- For both CALLS and PUTS
 - Sell-To-Open
 - Buy-To-Close and made money
 - Short Term Gain:
 - = Premium Sold – Premium Bought – Commissions
 - Short term gains are considered "Ordinary" Income
 - Taxed at your incremental income tax rate

bivio CDOJ_Chib November 28, 2012 18

The next scenario is when you Buy-To-Close the position and you end up making money.

This is actually the scenario that fits the majority of trades I do.

I start with a Sell-To-Open

and then I Buy-To-Close at a lower level so I make money on the overall trade.

The money made is viewed as a Short Term gain

It is equal to the Premium sold less the premium bought back at less commissions.

Again the short term gains are considered "Ordinary" Income and are taxed at your incremental income tax rate.



Here is an example of the BTC scenario. On October 19th, sold ALGN November \$26 PUT for \$.75 on four contracts. Paid commission of \$10.08 leaving a net collected of just under \$290.

On November 13 the contracts were bought back at \$.20 with a commission of \$7 and change.

The net short term gain would be shares time the premium collected (.75) – the shares times the premium spent to buy back (.20) less the two commissions on the option trades.

So the net was just shy of \$203.

I like this example because it shows how we captured the time premium. We sold a \$26 PUT on ALGN when it was at about \$28/share. A little over three weeks later ALGN had moved down to around \$26.50 but our option also had dropped from \$.75 to \$.20 because of the erosion of the time premium. This is the principle that works time and time again for those of us selling Covered Options.

Recap of Normal Situations

- “Closed” options
 - “Expired Worthless” - Short Term Capital Gain
 - “BTC” with a gain - Short Term Capital Gain
- “Exercised” options proceeds
 - PUTs - get “rolled” into Basis
 - CALLs - get “rolled” into Sales Price

bivio CDOO_ChibNovember 26, 2012 20

So let’s do a quick recap on our normal situations.

First all gains on options that are closed either by expiring worthless or are bought to close are taxed as short term gains. Losses, especially on Calls can be more problematic and we will talk about those shortly.

When options are exercised, the collected premium is rolled into the underlying security.

For PUTs the premium is subtracted from the strike to set the Basis.

For CALLs the premium is added to the strike to set the Sales Price.


Whether the overall gain on the trade is a Long or Short Term gain will be determined by the length of the time the underlying security was held in the case of a Covered CALL or is held in the case of a Cash Secured PUT.

SPECIAL SCENARIOS

bivio CDOO_Club November 28, 2012 21

Taxable Accounts

- Special Situations
 - Potential “Loss deferral rules” on Covered Calls
 - Wash Sale from selling Cash-Secured PUTs

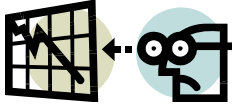


bivio CDOO_Club November 28, 2012 22

Now let’s talk about a few special situations that can arise when doing Covered Options.

First we will look at Potential Loss Deferral Rules that can kick in on covered calls that are bought back at a loss.

And then we will look at triggering a Wash Sale from selling Cash-Secured PUTs



POTENTIAL “LOSS DEFERRAL RULES” ON COVERED CALLS

bivio CDOO_Club November 28, 2012 23



Scenario

- August 3rd
 - AAPL @ \$619/share (Our Basis \$300)
 - Sold Sep 22 \$605 Calls for \$25 premium
- September 22nd
 - AAPL @ \$700/share
 - Bought back option for \$95 premium

Let's look at our first Scenario

So On August 3rd

Apple stock was @ \$619 Lets say we bought it more than a year ago and our basis is \$300

We decided to sell a September 22nd \$605 Call and collect a \$25 premium. This is an in-the-money option so we have a very high likelihood of being exercised.

By the time we get to September 22nd, Apple has risen to \$700. We decide we want to keep our stock as we are sure it is going to \$800

so we buy back the covered call at \$95/share, taking a \$70 loss per share. Ouch.

By buying back the option at a loss we are trying to take a \$70 short term loss and maintain our \$400 Long Term Gain on our stock.

This could trigger what the IRS calls "Loss Deferral Rules" These get complicated and may mean your loss is deferred a year.

Without going into all the details, you need to know that if you get into a scenario, you might need to find a CPA with a really sharp pencil to make sure your taxes are done right.

The COOL_Club Plan is to avoid this type of a situation.

First, as you know I normally avoid in-the-money options.

Next, don't buy back at a loss.

I believe if I sold a call and said I was happy to be called away, then I just let it be exercised.

Could Trigger Loss Deferral Rules

- Taking a \$70/share Short Term Loss to maintain a \$400 Long Term Gain
- Gets complicated
- Loss might be deferred a year
- Could require a CPA to do your taxes



COOL_Club Plan

- Avoid In-The-Money options
- Don't buy back at a loss
- Allow your stock to be called away

Example Using COOL_Club Plan

- Sell your stock at \$605 + \$25 premium
 - Net of \$630 (same as having \$700 stock and \$70 option loss)
- This avoids the potential problem with Taxes
- Yes, you will pay Long Term Capital Gains Taxes
- If that is a problem, don't sell covered calls

In this case where we did sell an in-the-money call we would receive \$605/share for the strike. We add to it the \$25 premium we collected so our net Sales price would be close to \$630 (less commissions). If we had bought back the option we would also had the equivalent of \$630 because we would own the shares at \$700 but we would have taken a \$70 loss on our covered call.

By allowing yourself to be called away you avoid potential problems with Taxes.

Yes this does mean you will have to pay (in this example) long term capital gains taxes on your \$330/share gain.

But, if you do not want to be selling and paying long term capital gains then you should not be selling covered calls. Being exercised is always a potential outcome.



TRIGGERING A WASH SALE FROM SELLING CASH-SECURED PUTS



Scenario

- October 12th
 - Bought AAPL @ \$630
- November 14th
 - Sold AAPL @ \$545
 - Loss of \$85/share
- November 27th
 - AAPL @ \$585
 - Sold AAPL Jan 19 \$610 PUT for \$40

bivio

COOL_Child November 28, 2012

29

In our next scenario we outright bought Apple at \$630 on October 12th (or maybe it was PUT to you at that level).

As we know Apple continued to fall and finally in November you decide to take a hit and book a loss on your Apple as you are concerned how far it may fall. You sell it at \$545 representing an \$85/share loss. Another ouch.

But then you notice a few weeks (less than 30 days) later that Apple seems to have bottomed and you decide you want to get back in.

You decide to sell an In-The-Money PUT for January 19th of next year. So you sell the \$610 PUT which is \$25 in the money and collect a premium of \$40. Being in-the-money improves your probability of being exercised and you would essentially be buying for roughly \$570/share or the \$610 Strike less your \$40 premium.

Could trigger Wash Sale

- Wash Sales happen when you buy back a stock you sold at a loss less than 30 days ago
- Selling deep-in-the-money PUT could trigger a Wash Sale
- The loss on the stock sale would be deferred
- Deep-in-the-money appears to be not well defined

bivio

COOL_Child November 28, 2012



A Wash Sale happens when you buy back a stock that you sold for a loss less than 30 days ago.

IRS believes that selling a deep-in-the-money PUT which has a very high probability of being exercised, is the same as actually just buying the shares. So you may have triggered a Wash Sale

A Wash Sale would mean the \$85/share loss that you took on your earlier sale would be deferred.

What complicates this further is that IRS definitions around what is a deep-in-the-money PUT are not very clear.

Once again this might require involving that sharp penciled CPA to handle it properly.

COOL_Club Plan

- Don't sell In-The-Money PUTs
- Do not sell PUTs on stocks you have recently sold at a loss until more than 30 days have elapsed
- ***This includes not Selling PUTs in your IRAs even when the stock sale was in a taxable account***

My recommendation to avoid this situation is fairly simple.

First I do not recommend selling in-the-money PUTs.

Second you do not want to be selling PUTs on stocks that you have sold at a loss within the last 30 days

This last note is really important. The IRS looks across taxable accounts and IRAs to look for wash sales. So you are not out of the woods if you sell the stock at a loss in your taxable account and within the next 30 days you sell a Cash-Secured-PUT on the same stock in your IRA.

Special Situation Recap



- Avoid getting into these scenarios
 - Buying back Covered CALLs at a loss
 - Selling PUTs on recent stocks sales that were losses

Let's do a quick recap.

Be aware of the special situations. I would recommend avoiding them if at all possible.

Don't buy back Covered Calls at a loss.


Don't sell Cash Secured PUTs on stocks that you have sold in the last month at a loss.

If you do these two things, then you do not have to worry about what is or is not a deep-in-the-money option.

If you follow the COOL_Club Plan, these scenarios should not come up. If you don't, I recommend getting your accountant's phone number on speed dial.


QUESTIONS?

NEXT MEETING Dec 5th 5:00pm ET
SELLING COVERED CALLS

 COOL_Club November 28, 2012 34

Before we go to an open floor let me just remind you that next week's session will be at 5pm ET and we will be looking at Selling Covered Calls.


OPEN FORUM

 COOL_Club November 28, 2012 35

At this juncture I would like to open up the floor to any questions.

In addition to questions, we can go through looking at covered options on any stock or index either CALLS or PUTs.

GOOD NIGHT AND GOOD SELLING

 COOL_Club November 28, 2012 36