Taxation of Derivatives Held by Investors: What to Know

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The taxation of derivatives and financial products has developed in an uncoordinated and piecemeal fashion. Tax rules have largely been enacted in response to what the government has perceived as abusive transactions — moments where taxpayers receive tax benefits that the government thinks should not be available. Anti-abuse provisions are added one by one to the Internal Revenue Code (Code) to shut down a particular “tax loophole.” At the same time, these anti-abuse provisions often provide elections or carveouts for certain transactions or taxpayers where the government wants to soften the blow of the new legislation. As a result, derivative taxation can vary widely, depending on the type of the derivative (option, futures contract, forward contracts, or swap); the underlying asset or index (stock, bond, commodity, digital asset, or currency index); the holding period of the derivative product or the underlying asset (if any); and the tax characterization of the taxpayer (investor, trader, dealer, or hedger).

This article provides an overview of derivatives taxation for those taxpayers characterized as “investors” for tax purposes. It focuses on three major tax provisions that investors and their tax advisors need to be aware of: wash sales, constructive sales, and tax straddles.

What Constitutes Derivative Transactions for Investors

Investors profit from price fluctuations in the derivatives they hold. Investors hold capital assets. The Code does not define capital assets but identifies those assets that are not capital assets. All other assets not enumerated in Code §1221 are taxed as 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. Because investment assets are not held for business reasons derivatives related to investment activities are treated as capital assets. Gain and loss on derivatives is capital for investors. Investing is not treated as a trade or business, so investment expenses are not deductible under Code §162.

If a taxpayer holds a capital asset for more than one year, 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 the tax characterization as an investor has tax consequences.
General Tax Rules That Apply to Taxation of Derivatives

Four key tax rules need to be considered. First, as stated above, the character of gains and losses on derivative transactions is capital or ordinary, based on the characterization of the taxpayer. Investors and traders generally receive a capital gain or loss on their transactions, while dealers and business hedgers generally receive ordinary tax treatment.

Second, whether the taxpayer has held the capital asset for the long-term holding period (more than one year), or the short-term period (one year or less) determines the tax treatment of the sale or exchange. Long-term capital gains get favorable tax treatment, while short-term gains are taxed at ordinary income rates. If, for example, an investor holds an option or forward contract and delivers shares of stock pursuant to the terms of that contract, the holding period of the stock determines whether the investor receives long-term or short-term treatment.

Third, buyers of cash-settled options (that is, options that settle with a cash payment rather than an exchange of property) are taxed based on the length of time they held the option. Sellers of cash-settled option contracts, on the other hand, receive short-term capital gain or loss regardless of how long they held the short position. The tax issues faced by investors entering into stock options is discussed in the companion article Taxation of Stock Options Held by Investors.

And fourth, special tax rules apply to certain types of derivatives. For example, notional principal contracts (NPCs) are multi-period swaps, where payments are exchanged on a periodic basis. Up-front (non-periodic) payments (such as premiums) and periodic payments are taxed at ordinary income rates for all taxpayers, including investors and traders. Periodic and non-periodic payments generate ordinary income and loss even though an NPC is a capital asset in an investor’s hands. If the NPC is terminated before maturity, the termination payment is treated as capital (for investors and traders) or ordinary (for dealers and hedgers).

Another special rule applies to “section 1256 contracts,” including futures contracts and exchange-traded options on broad-based stock indices. Under Code §1256, investors holding section 1256 contracts report 60 percent long-term and 40 percent short-term capital gain or loss, without regard to their actual holding period for the contracts. In addition, gains and losses on section 1256 contracts open on the last business day of the tax year are marked-to-market at 60/40 rates and taxed as if sold on that day.

How Wash Sales Avoid Tax Abuse

The wash sales rule at Code §1091 is an obvious example of an anti-abuse rule enacted to stop what the government viewed as abusive transactions. The wash sales rule prohibits a taxpayer from claiming a tax loss on the sale of stock or securities if the taxpayer acquires substantially identical stock or securities within a 61-day prohibited period (that is, 30 days before or 30 days after the sale). This rule prevents taxpayers from taking losses on stock or securities when they have not changed their economic position. Entering into derivative transactions during this prohibited period can also create a wash sale. For example, if an investor sells stock for a tax loss and buys a call option to acquire the same stock within the 61-day prohibited period, this triggers a wash sale and a tax loss is denied on the sale of the stock at a loss.

Constructive Sales for Tax Purposes
Another anti-abuse rule that is at Code §1259 applies to transactions that are “constructive sales.” By way of background, an investor enters into a short sale when the investor borrows stock or securities from another person (typically a securities dealer) and then sells the borrowed securities to a third party. The investor agrees to return identical securities to the lender at a future date. Entering into short positions is not tax efficient because short positions are taxed at the short-term capital gains rate without regard to the investor’s holding period.

Entering into a short position can trigger a constructive sale, which is treated as a taxable sale even though there was no actual sale. For example, if an investor held substantially appreciated shares of stock and sold the same shares short (a short-against-the-box strategy), the transaction is taxed as a constructive sale and the investor owes tax as if she had sold the shares outright. The constructive sales rule was enacted to shut down transactions like the short-against-the-box transaction discussed above where investors could eliminate the risk of a concentrated stock position without triggering a taxable event.

Derivatives used to create a synthetic short position would also trigger a constructive sale. This means that a futures contract, forward contract, or a transaction that has “substantially the same effect” as a short position can be a constructive sale. A constructive sale might also be triggered if the short position is entered into on a “substantially identical” security.

Transactions that do not eliminate “substantially all” of the taxpayer’s risk of loss and opportunity for gain are not subject to the constructive sales rule. This explains the popularity of certain forward contract transactions that call for delivery of property that is not substantially fixed in the delivery amount (a variable forward) and certain option positions, such as collar transactions.

But what happens when the situation is not so clear cut? What if the investor’s risk of loss or opportunity for gain on a position is reduced but not eliminated? The investor might be able to avoid a constructive sale, but now enters into the realm of the straddle.

**Tax Straddles and Derivative Transactions**

Not to be confused with an “option straddle” trading strategy, a straddle happens when the investor enters into offsetting positions where the value of one position moves inversely to the value of another position. The positions in a straddle substantially diminish the investor’s risk of loss while holding the straddle, so the investor cannot deduct losses on one of the straddle’s offsetting positions if the other position has untaxed built in gains. Assuming an investor holds a long stock position, some straddle examples include:

- selling a call option (the long stock position offsets the short call)
- buying a put option (the long put is actually a short position that offsets the long stock)
- entering into a collar transaction (the long put offsets the long stock and the stock offsets the short call)

The straddle rules are quite complex, affecting how losses are recognized and how holding periods are calculated. While an investor holds a straddle, losses are deferred until the taxpayer closes out the offsetting positions (or successor positions). If the long stock position was held for less than one year before the straddle was entered into, the investor’s holding period in the stock position resets to
zero and stays at zero until the straddle is closed out.[10]

An important exception to the straddle rules is available to certain investors who own stock and sell covered calls against that stock. This is a classic buy-write strategy. Qualified covered calls (QCCs) are call options with more than 30 days to expiration that are not deep in-the-money (meaning that the call is not lower by more than one strike price below the prior day’s closing price).[11] Let’s say, for example, taxpayer A owns XYZ stock and she wants to sell covered calls to earn extra money on the premiums she receives from selling the option. As long as the call options meet the tax requirements for QCCs, A can avoid application of the straddle rules. Those XYZ shares that A has held for more than a year can qualify for favorable long-term capital gain rates, and A does not need to worry about deferring any losses while she holds offsetting positions with built-in gains.[12]

The straddle rules can apply to an investor who holds a portfolio of stocks and enters into an index option that is “substantially similar” to the portfolio.[13] If A holds a portfolio of stock and sells an index option, as long as her portfolio is not substantially similar to the short index option position, she does not have a straddle. She could selectively sell individual stocks with losses in them to harvest tax losses. These losses could be used to offset realized gains in her stock portfolio, as long as she does not fall into the wash sale rule.

Conclusion

Derivative trading strategies can have unexpected tax consequences. Investors should consult with their tax advisors before investing in new derivative trading strategies. The patchwork nature of the Code provisions discussed in this article and the companion article Taxation of Stock Options Held by Investors makes tax management difficult for portfolio managers, investors, and their tax advisors. Taxes have a major impact on the overall profitability of a trade, so ignoring these rules can result in significant tax liabilities and reduce transaction profitability. Careful attention should be placed on tax considerations before embarking on new trading strategies.

[1] Taxpayers may also be subject to the additional net investment income tax of 3.8 percent from the Affordable Care Act.

[2] A cash-settled derivative is one where the underlying asset or index does not exchange hands at settlement. Instead, one part compensates the other with a cash payment that is equivalent to the excess value of the position. As an example, suppose that a call option with a $50 strike price is exercised when the underlying equity price is $60. Rather than the option buyer giving the seller $50 in exchange for the physical share of equity, the seller agrees to simply pay the difference between the share price and the strike price, or $10, in cash. Special rules apply, for example, to short sales, puts, and written options.


[4] Code § 1091(a) provides that “In the case of any loss claimed to have been sustained from any sale or other disposition of shares of stock or securities where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange on which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities, then no deduction shall be allowed…."

[5] Investors often enter into short sales to manage their risks in long/short, market neutral, and
arbitrage strategies. See Peter E. Pront and John E. Tavss, Significant Tax Considerations for Taxable Investors in MNS, Chapter 10, Bruce Jacobs and Kenneth N. Levy, Market Neutral Strategies (Wiley 2005).


[7] Constructive sales include transactions where the owner of an appreciated financial position (AFP) enters into one of three transactions: (1) a short sale of the same or substantially identical property; (2) an offsetting NPC with respect to the same or substantially identical property; or (3) a futures contract or forward contract to deliver the same or substantially identical property. The appreciated position can be either long or short. The constructive sales rule is limited to these transactions unless the Treasury issues regulations including transactions that have the same effect of eliminating substantially all of the taxpayer’s risk of loss and opportunity for gain.

[8] An option straddle involves the simultaneous purchase of both a put option and a call option on the same underlying securities with the same strike price and the same expiration price. The transaction is only profitable if the stock risks or falls more than the total premiums paid by the purchaser of the options.


[10] See Code § 1092(a). Tax straddles trigger other adverse tax consequences, such as interest on borrowings against the straddle being added to the cost basis of the stock, and potentially never being deductible under Code § 263(g). In addition, dividends received on straddled stock are taxed as ordinary income instead of at the favorable qualified dividend income rate under Code §§1(h)(11) and 246(c).


[12] There are also “mixed straddles” and the ability to make various elections to “identify” a straddle. The elections can make the accounting easier and reduce some of the negative consequences of loss deferral.


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