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BACK IN THE STRADDLE AGAIN

HEDGE FUNDS NEED TO BE AWARE OF TAX IMPLICATIONS.

Hedge funds undertaking positions involving the purchase and sale of options need to be cognizant of the tax implications of such transactions, particularly as they relate to wash sales.

"In order to run accurate and audit-ready tax analyses, firms need to understand how straddles gains and losses affect wash sale calculations. This involves complicated calculations that take into account numerous interdependencies, known as interweaving.

"Any auditor or software system must employ an exact process when calculating adjustments for straddles," George Michaels, CEO of G2 FinTech, told Markets Media. "The IRS can be very tolerant of mistakes provided that an unbiased process has been consistently applied."

Interweaving involves the interaction between different sections of

the tax code, in particular the interplay between Section 1092 (straddles)

and Sections 1091 (wash sales), 1233 (short sales) and 1259 (constructive sales), and how that relationship ultimately impacts capital gains calculations.

In the case of straddles, which involve buying and selling long and short positions, the IRS can flag such transactions as tax shelters if they're not properly structured.

The seminal case in tax law on this issue is the "silver butterfly," said Michaels.

During the 1960s, investors bought butterfly straddles in silver futures, consisting of a package of long and short futures contracts, so constructed that the value of the overall package fluctuates less than the value of the component contracts.

The IRS brought suit against investors who use straddles for this purpose, claiming that since the likelihood of eking out a profit on the straddles was minimal, their only purpose could be tax avoidance, and therefore they should be disallowed.

If properly liquidated, the straddle can create short-term capital losses in one year, which are balanced by long-term capital gains in the next. Thus, investors with short-term capital gains can offset them against the short-term losses.

Another potential problem for hedge funds is a wash sale, which is generally described as selling stock at a loss, and buying substantially identical securities within 30 days before or after the sale.

The wash sales rules are considered to take higher precedence than straddles rules.

"There are frequently cases where both sets of rules take effect, but where a loss can be disallowed for 1091 or 1092, then 1091 disallowance rules kick in first," Michaels said. "Once any disallowance is made for wash sales, if the loss lot still has a loss, then the loss from the lot loss may still be disallowed for straddles."

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—GEORGE MICHAELS

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