Tax Implications of Straddles

2/15/2012

White Paper

Section 1092 of the tax code governs treatment of straddles. This paper covers 'basic' and 'identified' straddles, leaving 'mixed' straddles for a future discussion. Complete with examples, we discuss practical applications of 1092 as related to cost basis adjustments, holding period adjustments for lots tied to a straddle, and the basic elements involved in calculating disallowed losses. We explain how 'covered calls' are identified and excluded from straddle computations. The paper also touches upon some of the basic interactions between section 1092 and sections 1091, 1233, and 1259.

By George Michaels

with Daniel Tilkin

INTRODUCTION

A straddle is a pair of transactions that is created by taking two offsetting positions that share the same underlying security. One of the two positions holds long risk and the other is short.

A “tax straddle” is a straddle that has been constructed solely as a tax shelter. A taxpayer constructs a tax straddle to artificially create taxable losses in order to offset pre-existing gains from unrelated transactions. As is normal, one of the two positions accumulates an unrealized gain and the other an unrealized loss. The position with the loss is closed out prior to the end of the tax year, realizing a loss sufficient to counter the pre-existing taxable gains. Soon afterwards, when the new tax year opens, a replacement position can be created in order to offset the risk from the retained position. Through repeated use of this strategy, gains can be indefinitely postponed from one year to the next.

A History

Throughout the 1960s and 1970s, commodity straddles and other transactions, such as “T-Bill Straddles” and “Cash and Carry Trades” were aggressively marketed by brokers to non-professional investors as tax shelters. The most well-known example of straddle abuse is the now infamous “Silver Butterfly Case.” The case was based on the actions of two investors, who, in 1973 executed 84 long futures transactions and 84 short futures transactions on silver. By the end of the calendar year, they had both significant unrealized losses and gains on the individual positions with a net profit of close to zero. They then closed out some of the losing positions before year end to offset some short term real-estate gains they had made earlier in 1973. The IRS decided to audit and disallowed the losses. In 1977, the IRS published a ruling (77-185) to support its decision. Unfortunately, there was no support in the tax code for this ruling, so the issue had to go to Washington for resolution.

When this issue came to Congress’s attention, it sparked an epic battle between Dan Rostenkowski (Democratic Representative from Illinois) and Patrick Moynihan (Democratic Senator from New York). Moynihan and others fought to close this loophole. At the climax of the struggle, when the issue came to a vote, Moynihan exclaimed that before learning about straddles, in particular butterfly straddles, he had assumed “a butterfly straddle must refer to a highly pleasurable erotic activity popular during the Ming Dynasty.” (Schwartz, 1999)

In the end, Moynihan won the fight and Congress added section 1092 to the tax code via Title V of the Economic Recovery Tax Act of 1981 (ERTA). Simply put, section 1092 disallows losses on the retired leg(s) of a straddle to the extent of the unrealized gain on the non-retired leg(s) at the end of the tax year.

The next year, on March 5, 1982, the Tax Court decided that the “Silver Butterfly” employed in 1973 as a tax shelter was within the law. Since the code was changed in 1981 (via ERTA), all tax straddles executed prior to ERTA ultimately were considered legitimate.

Exemptions

In 2002, the regulations were changed such that an exemption from section 1092 was created for Qualified Covered Calls (QCCs), which are fully legitimate trades that resemble straddles but are created as an income enhancement rather than tax-evasion strategy. Another exception to the general rule from 1981 was when all legs of the straddle were equities. In this case, section 1233 (short sales) caused similar effects to the holding period of these positions. This was changed in 2004 when Congress amended the law so that BOTH sections 1233 and 1092 must be considered in this situation.

DEFINITIONS

Generally speaking, there are two classes of straddles: **basic** and **identified.** These two classes differ in terms of how transactions become associated into the straddles. Additionally, groups of transactions can also be delineated as **Qualified Covered Calls.** This has the effect of excluding that group of transactions from being considered a straddle. However, the individual elements of the QCC can be included as elements of other straddles.

An **Identified** straddle is created when the taxpayer flags two or more transactions to be grouped together as part of a straddle. A set of positions cannot be flagged as an identified straddle if it is part of a larger straddle.

A **Basic** straddle occurs when you have two or more positions that are offsetting, and none of these positions are in an identified straddle.

A **Qualified Covered Call** is an exception to the straddle rule. A QCC is a covered call that meets certain requirements defined in the tax code.

A **Loss Lot** is any tax lot retired during the analysis period with a realized loss.

A **Loss Security** is the security held by the Loss Lot.

A **Loss Family** is the list of all securities in which there can be positions offsetting to a Loss Security.

A **Successor Trade** is a trade that is made on any security in the same loss family as the loss security and is (a) offsetting to a position that is offsetting to the loss lot, and (b) entered into within 30 days of the transaction that created the loss lot.

A **Successor Lot** is a tax lot that has been created by a successor trade.

The **Straddle List** is the list of all positions associated with a given loss lot. The generation of this list is a precursor step for creating the candidate positions. Every loss lot must have a candidate list constructed and maintained, even those with empty lists.

Candidate Positions are those members of the straddle list that have unrealized gains at the end of the year. Any lots open at period-end that contain unrealized losses are NOT included in the candidate lot list even if they are otherwise associated with the same straddle.

STRADDLE PROCESSING

Any auditor or software system must employ an exact process when calculating adjustments for straddles. The IRS can be very tolerant of mistakes provided that an unbiased process has been consistently applied. This section walks through the elements of just such a process.

Offsetting Positions Grouping

A thorough understanding of the taxpayer's list of held securities is needed in order to determine which positions are offsetting and which can qualify as successor positions. For our purposes, we will assume that securities can be grouped into families where every position with a long risk direction in a family is offsetting to every position with a short risk direction in that family and is not offsetting with any position not in that family. Every security in a family must be associated with a risk direction, either long or short. Most equities and call options would be considered 'long' securities and put options are a good example of 'short' securities. A short position on a given security makes the risk direction of the position opposite to that of the security.

Identification

Identified straddles have their transactions explicitly associated with one another. Any loss lot associated with either the original position or any of its offsets might have its loss disallowed. A loss lot contained in an identified straddle must have a candidate lot list constructed for it. This list is constructed from those lots that have been opened by other transactions that (a) are identified as part of the same straddle as the transaction that created the loss, (b) are open at analysis at period end, and (c) carry an unrealized gain.

Basic straddle groups are built by traversing the entire universe of loss lots that are not in identified straddles, and building a candidate lot list for each. To accomplish this, it is first necessary to verify if in fact you have a straddle. To do this, you must find an offsetting position for the loss lot. Throughout the life of the loss lot, all positions on the loss family must be considered. If any lot is open on a security in the loss family with the opposite risk direction to that of the loss lot, you have a straddle. To determine the risk direction of the loss lot, you must consider the direction of the security as well as the direction of the trade that created the lot. If both the risk direction of the security and the trade are the same, the risk direction of the lot is considered long. If the two are different, the risk direction is short. *For example, if the trade is long, but the security is short (Buy a Put), the risk of the lot is short.*

Both the original trade and all offsetting trades are part of the basic straddle, and are added to the straddle list. In addition, all successor trades are added to the straddle list for the loss lot, as well as any trades that open offsetting lots to the successor lots.

Once the straddle list is complete, the candidate lot list can be built by identifying lots in the straddle list that (a) were open at analysis at period end, and (b) carry an unrealized gain.

QCCs

There are a number of rules for when this section can be applied. Typically, a covered call is comprised of a long equity position and a short call option. The principal rules are (a) the option is granted more than 30 days before it expires, and (b) the option is not deep-in-the-money, as defined by § 1092(c)(4)(C). The effect is that these trades are not considered to be a straddle for tax purposes. However, the individual positions can still be part of a straddle with other positions that are not part of the qualified covered call--in which case the standard straddle rules apply.

Dis-Allowance

In the case of identified straddles, you simply need to determine if any of the positions in the identification group are still active at the moment any one position realizes a loss. If any are, then the loss associated with the loss lot is disallowed in its entirety.

Basic straddles follow a different rule for disallowing losses. The loss amount tied to the loss lot is disallowed to the extent that any lots in the candidate lot list have unrealized gains at year end. Any losses in excess of the gains in the candidate positions are allowed. One important thing to remember is that the candidate position list only contains lots with unrealized gains. So even if your unrealized losses on lots created by the straddle vastly outweigh your unrealized gains, you can still experience dis-allowed losses on your loss lot.

Cost Basis Adjustments and Re-Allowance

In the case of identified straddles, when you experience a disallowed realized loss, then cost basis adjustments need to be made to the active open positions. This cost basis adjustment is applied pro-rata to any candidate lots with an unrealized gain at the moment the loss is disallowed. This allows for a re-allowance of the disallowed loss as these adjusted lots are retired. If there are no positions with unrealized gain, the taxpayer is allowed to apply the basis adjustment in any reasonable and consistent manner. The rules for allocation when unrealized gain is present is per 1092(a)(2)(A)(ii). Furthermore, 1092(a)(2)(A)(iii) governs allocation of cost basis adjustment when none of the open positions carry unrealized gains.

In the case of a basic straddle, you place the disallowed loss in a limbo state. In the following year, if some of the candidate lots are still open at the end of the year, then the unrealized gain of all surviving candidate lots is considered (again, ignoring unrealized losses). If this unrealized gain is greater than or equal to the limbo amount, then no action is taken. If the new unrealized gain is less than the current limbo amount but greater than zero, then the difference between the current unrealized gain and the limbo amount is re-allowed and the limbo amount is reduced to the current unrealized gain. If all candidate lots are retired or none of the candidate lots have an unrealized gain, then the limbo amount is re-allowed.

Holding Period Adjustments

For all straddles, any lot held long enough to qualify for long term capital gains at the point the straddle came into existence, shall be considered long term. Otherwise, the holding period shall be considered to begin at the time when no offsetting positions are held. Exceptions to this are detailed in 1.1092(b)-2T(2)(b) of the tax regulations. This prevents taxpayers from using 1092 to convert long term losses into short term losses.

INTERACTIONS WITH OTHER TAX RULES

Wash Sales

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 dis-allowance rules kick in first. Once any dis-allowance 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.

Also, a lot may have a book gain associated with it, but if it has a cost basis adjustment due to being a replacement lot in a wash sale, it can become a loss lot for straddle purposes.

Furthermore, a candidate lot that has a cost basis adjustment due to being a replacement trade for a wash sale must be considered at its adjusted costs basis for determination of unrealized gains. This can potentially reduce or eliminate its ability to disallow losses on the loss lot.

Lastly, with identified straddles, since the remaining open positions may carry cost basis adjustments, this can affect wash sales. When one of these positions is retired, the cost basis can potentially change a realized gain into a realized loss. This has the potential for creating a new wash sale, should there be a valid replacement position, where a traditional GAAP-based wash sale analysis would fail to identify it. In the case where said position was retired with a GAAP loss, the total loss is increased so the dis-allowance is increased if a wash sale was already indicated.

Constructive Sales

Cost basis adjustments due to identified straddles can also modify the amount of realized gain that must be taken when a constructive sale occurs. This can even convert a GAAP gain to a loss, eliminating the constructive sale entirely.

Also, since constructive sales also produce cost basis adjustments, a lot from a book perspective that has no loss can now be considered a loss lot when the cost basis adjustment from the straddle is considered.

Qualified Dividends

If the equity that produced a dividend did not qualify for long term capital gains treatment prior to becoming one of the legs of a straddle, as stated above, the acquisition date for the lot is considered to be the date the straddle was terminated. Therefore, the counting period for qualification for preferential dividend treatment must be started when the offsetting leg is retired.

If the equity was qualified for long term capital gains treatment, then the mitigation of risk provided by the straddle will likely suspend the counting period for dividend qualification while the straddle is active. When searching for the 61 total days needed for qualification, you may count the days before the straddle as well as the days after the straddle.

EXAMPLES

Example 1 – Basic Straddle

Activity: The fund buys a call option for 100 shares of ABC stock on January 5th, 2011. The fund buys a put option for 100 shares of ABC stock on January 6th, 2011. The fund sells the call option on December 1st, 2011 for a loss of $11.00. On December 31st, the put option shows an unrealized gain of $5.00.

Result: $5.00 of the $11.00 loss is disallowed. The $6.00 loss is allowed for the tax year of 2011, and the $5.00 loss is allowed in a later taxable year.

Example 2 – Identified Straddle

Activity: Same as example 1, but the fund 'identifies' the two transactions as belonging to a single straddle.

Result: The entire $11.00 is disallowed in the tax year of 2011; the cost basis of the put option is adjusted upward by $11.00.

Example 3 – Covered Call

Activity: The fund buys 100 shares of ABC stock on January 5th, 2011. On December 30th of 2011, the fund sells short ('writes') an out-of-the-money call option with an expiration date of June 30th, 2012. On December 31st, the fund sells the ABC shares for a $10.00 realized loss. The short call option shows an unrealized gain of $5.00 at close of business, December 31st, 2011. These transactions meet the requirements of being a qualified covered call.

Result: Although the two transactions would normally be tagged as a basic straddle, since they were exempted by being qualified as a QCC, the $10.00 loss is allowed in the tax year of 2011.

Example 4 – QDI Interaction

Activity: The fund buys 100 shares of ABC stock on January 5th, 2011. On October 19th, 2011, the fund sells short 100 shares of ABC stock. On October 21st, the fund covers the short position in its entirety. The cover settles on October 26th. On October 31st, 2011, the stock pays a $1.00 per share dividend. On December 1st, 2011 the fund sells the position in ABC.

Result: The dividend is not qualified. The long shares of ABC were NOT held long enough to qualify for long term capital gains consideration at the moment the short position was created on October 19th. The short position created a straddle that existed between the 19th and 26th of October, 2011. Because the long lot was not long term when the straddle was created, the holding period for qualification purposes had to reset to the date the straddle was closed out, October 26th. Between October 26th and December 1st 36 days transpired, which is well short of the 61 necessary for qualification purposes. Had there been no straddle, the fund would count all the days between the start of the 121-day qualification period (September 1st, 2011) and the date the position was closed (December 1st, 2011) – 91 days total – which would have qualified the dividend.

Example 5 – Wash Sale Interaction

Activity: The fund buys 100 shares of ABC stock on January 5th, 2011. The fund sells short 100 shares of ABC stock (at a price that does not trigger a constructive sale) on January 6th, 2011. The fund sells the long shares on January 31st, 2011 for a loss of $10.00. The fund buys 100 shares of ABC stock on February 1st, 2011. On December 31st, the short position shows an unrealized gain of $5.00 and the long position acquired on February 1st is still open.

Result: The entire loss of $10.00 is disallowed as a wash sale. Although the short position created a straddle that could have theoretically disallowed $5.00 had the second long position not been created, this becomes irrelevant. The wash sales loss takes precedence and the same loss cannot be disallowed twice (that would be silly).

SUMMARY

This paper discusses basic and identified straddles and gives examples of how to apply the guidelines set forth in section 1092 when calculating cost basis adjustments, holding period adjustments (for positions tied to a straddle), and disallowed losses. We also explain how covered calls are identified and how they are excluded from straddle computations.

BIBLIOGRAPHY

Schwartz, M. F. (1999). *Pit Bull: Lessons from Wall Street's Champion Day Trader.* New York: Harper Collins.

This white paper is part of a series that provides tips and analyzes issues related to performing tax analyses on securities transactions. G2's white paper series examines the challenges firms encounter when tackling the complex process of identifying and analyzing wash sales and other tax events. For more information or additional free resources on this and related topics, please visit G2's **Tax Analysis for Securities Transactions Resource Page** at http://g2ft.com/taxanalysisforsecuritiestransactionsresources.html

G2 FinTech (www.g2ft.com) specializes in tax analysis and compliance software for the investment management community. TaxGopher®, G2's flagship product, is a sophisticated tax analysis engine for cost basis adjustments. TaxGopher enables firms to meet their compliance requirements by providing accurate information on taxable gains and losses. G2 also offers software modules for UCITS IV Directives and German Tax. The firm's software products help Clients solve business problems that have been traditionally addressed with in-house code or expensive third-party services. G2 Clients include leading Hedge Funds, Brokerage Firms and Fund Administrators. The company also maintains a practical resource for the tax and accounting community that addresses real-world cost basis challenges. Visit G2's Tax Analysis for Securities Transactions Resource Page (http://g2ft.com/taxanalysisforsecuritiestransactionsresources.html) to learn more.

99 Park Avenue Suite 330 New York, NY + 1 212 867 5415