

## **Tax Tricks and Traps of Investing 2007**

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### **Tax Rules of the Road**

Long-term holding = more than one year

Tax rate = 15% on stocks; 28% on collectibles

For taxpayers in the 10% and 15% regular tax brackets in 2008-2010, net capital gain will not be taxed.

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### **Tax Rules of the Road**

Wash sales = sell at a loss and acquire substantially identical securities within the period 30 days before or after sale

Short sales = destroy holding period if done while holding substantially identical property short-term

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### More Rules of the Road

Constructive Sales—taxpayer is required to recognize gain as if the position was sold at its FMV on the date of the constructive sale

Exist when taxpayer enters into a short sale of the same or substantially identical property

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### More Rules of the Road

Straddles—offsetting positions with respect to personal property

Carrying charges must be capitalized

Recognized loss in one position must be capitalized to the extent of unrecognized gain in the offsetting position

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### More Rules of the Road

Deducting Investment Interest

Investment interest expense is deductible to the extent of investment income

Investment income does not include LTCG or Dividends taxed at the 15% rate

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## Investment Choices

Equity Options

ETFs

Index Options

Hedge Funds

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## Trader vs. Investor

Dealer—carries inventory and sells to customers

Investor—is principally seeking longer-term returns, dividends and interest

Trader—seeking short-term profit swings

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## Trader vs. Investor

Investor expenses = Sec. 212 deductions

Trader expenses = Deductible above-the-line

Gain or loss for each = Capital

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### Section 475(f) Election

Traders can make this election to mark-to-market their trading positions at year-end and tax the unrealized gain or loss as ordinary, along with treating all realized gains and losses as ordinary.

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### Section 475(f) Election

The election must be made within the first 90 days for a new taxpayer

For an existing individual taxpayer, the election must be made by April 15 of the year for which the election is to be effective

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### Section 475(f) Election

- William G. Holsinger et ux. v. Commissioner (T.C. Memo. 2008-191; 8/11/08)—Taxpayer was held not to qualify for trader election

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## Tax Tricks and Traps of Securities Investing

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### I. The General Rules

A. The maximum tax rate on net capital gains (the excess of long-term gains over short-term losses) on securities and real estate is 15% for taxable years ending after May 5, 2003 and before January 1, 2009 (rather than the previous 20% tax rate).

1. The holding period to achieve long-term status is more than one year.
2. For taxpayers in the 10% and 15% regular tax brackets in 2008-2010, net capital gain will not be taxed.

Planning Point 1: This means that gifting highly appreciated stock to an elderly parent in the 15% regular tax bracket could result in 0% tax rate (versus 15%) when the stock is sold.

Example: A \$2,000 net capital gain would be subject to \$300 in tax at the taxpayer's 15% rate and nothing at the elderly parent's 0% rate.

Planning Point 2: For 2008, the kiddie tax applies to children 18 and younger—and to those up to age 24 if they are full-time students and dependent on their parents—so these children will have their investment income taxed at that parents' top marginal rate.

Planning Point 3: Retirees seem to have one of the more extensive opportunities to take advantage of this provision. If they have choices of where to take income distributions, they should do so from Roth accounts or savings rather than from taxable retirement accounts. Also, they may have appreciated bonds (purchased when interest rates were high) that still have capital gains. They may also want to defer taking Social Security during this period. Also, consider doing elective medical procedures while income is so low.

3. These rates apply for alternative minimum tax purposes as well as regular tax purposes.
4. Beginning in 2011, the 20% and 10% rates will again apply to net capital gains.

5. Collectibles generally continue to be subject to a maximum rate on net capital gains of 28%.
  - a. However, certain newly minted coins issued by the federal government, or coins issued by the states, will not be deemed "collectibles."

6. The maximum tax rate on the gain from the sale or exchange of depreciable real property is 25% for gain that represents depreciation recapture, with any remaining gain subject to the lower 15% rate.

Planning Point: There is an opportunity to attribute appreciation (and therefore taxable gain) to the land rather than the building in many cases, thus resulting in taxation of less of the overall gain at the 25% recapture rate and more at the 15% rate.

- B. Certain dividends received by an individual shareholder will be taxed at the same rates that apply to net capital gain.
  1. A property distribution qualifies as a "dividend" if it is made out of earnings and profits.
  2. To be eligible for the reduced tax rate, the dividend-paying stock must be held by the shareholder for more than 60 days of the 120 day period that begins 60 days before the ex-dividend date.
    - a. The holding period is tolled for days on which the shareholder has diminished risk of loss through an option to sell, a short sale, or granting an option to buy (other than a qualified covered call).
  3. An extraordinary dividend eligible for the preferential tax rates will generate a long-term capital loss (to the extent of the amount of the extraordinary dividend) if there is a loss on the subsequent sale of the shares.
    - a. A dividend is extraordinary where the distribution equals or exceeds 10% of the basis of common stock or, at the shareholder's election, the value of the stock as of the day before the ex-dividend date. (A 5% threshold applies for preferred stock.)
  4. Dividends paid by RICs and REITs that are eligible for reduced rates may not exceed the amount of qualified dividends received by the RIC or the REIT.
- C. Short-against-the-box transactions and similar devices previously used to postpone gain recognition indefinitely are subject to constructive sale rules.

1. Where there is a constructive sale of an appreciated financial position, the taxpayer is generally required to recognize gain as if the position was sold at its fair market value on the date of the constructive sale.
  - a. Holding period is determined as if the position were acquired on the date of the constructive sale.

Observation: You begin to count from the day after the constructive sale for purposes of determining long-term holding period.
2. A constructive sale exists when the taxpayer (or a related person as defined in Section 267(b) or 707(b))
  - a. enters into a short sale of the same or substantially identical property;
  - b. enters into an offsetting notional principal contract with respect to the same or substantially identical property; or
  - c. enters into a futures or forward contract to deliver the same or substantially identical property.
  - d. A constructive sale also exists if there is an appreciated short position with respect to property and the taxpayer acquires the same or substantially identical property.
  - e. The Treasury Secretary has been given broad regulatory authority to incorporate other transactions into the constructive sale definition where they have substantially the same effect as those enumerated in the statute.
3. There is an exception from the constructive sale rules where a transaction is closed before the end of the 30th day after the close of the taxable year and
  - a. the taxpayer holds the appreciated financial position throughout the 60-day period beginning on the date such transaction is closed without reducing the risk of loss on the security (as described in Section 246(c)(4)).
4. The constructive sale rules generally apply to any constructive sale after 6/8/97.
  - a. However, if before 6/9/97, the taxpayer had entered into a constructive sale and identifies in his records the components of

the constructive sale on or before 9/3/97, that transaction will be ignored for purposes of the new gain recognition rules.

- b. In the case of a decedent dying after 6/8/97, if there was a constructive sale on or before that date and it remains open at death, such position and the related property will be treated as property constituting rights to receive income in respect of a decedent.

## II. Other rules

- A. If you sell shares at a loss and within the 30-day period before or after the sale you acquire substantially identical securities, Section 1091 specifies that you have a wash sale.
- B. Generally, if you have offsetting positions with respect to personal property, you have a straddle under Section 1092.
  - 1. An offsetting position exists if there is a substantial diminution of risk of loss by the taxpayer holding two separate positions in personal property.
  - 2. Stock against stock now constitutes a straddle.
- C. Where a straddle exists, carrying charges must be capitalized, recognized loss in one position must be capitalized to the extent of unrecognized gain in an offsetting position, and holding period does not accrue in any of the positions that are part of the straddle.
- D. Under Section 1233, gain on the closing of a short sale is considered short-term if property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for not more than one year or is acquired by the taxpayer after the short sale but before the short sale is closed.
  - 1. This is the rule even if property held for more than one year is used to close the short sale.
  - 2. Furthermore, the holding period of the substantially identical property becomes tainted and begins again on the closing of the short sale.
    - a. This rule only applies to an amount equal to the quantity sold short and applies in the chronological order of acquisition of the substantially identical property.
  - 3. Where substantially identical property has been held by the taxpayer for more than one year at the time the short sale is entered into, any loss on

the closing of the short sale is treated as a long-term loss, even if the property used to close the short sale was held for not more than one year.

### III. Year-end Tax Planning

#### A. Use wash sale to postpone loss recognition

##### 1. Why?

- a. You have too many short-term losses which will now offset long-term gains; or
- b. You have an unexpected long-term capital gain when you were planning to use a long-term loss to offset short-term gains.

##### 2. How?

- a. If it was not more than 30 days ago that you sold your stock at a loss, simply repurchase the holding, subjecting that trade to the wash sale rules.

#### B. Use the wash sale rules to tack holding period when the losing stock you recently disposed of turns around.

#### C. Give appreciated stock to family members who are in the 15% bracket and who will pay 0% long-term capital gains rates.

#### D. Gift appreciated long-term capital gain stock to charity.

##### 1. Section 1256 requires that a taxpayer who donates the long-term capital gain portion of a regulated futures contract to charity recognize gain on the mark-to-market amount. (Greene v. U.S., U.S. Dist. Ct. for the Southern District of NY, 81 AFTR2d Par. 98-586)

- a. The Greenes contended that their donation of futures contracts yielded them no "economic gain" because they received no money or property in exchange for the donation and that under Section 1256(a)(2) they should be entitled to a "proper adjustment" against their mark-to-market gain so that the gain would be reduced to zero.

##### 2. The charitable contribution deduction for non-publicly traded stock was limited to the stock's basis where the taxpayers failed to obtain an appraisal, even though there were bona fide, arm's-length,

contemporaneous transactions in the stock. (John T. Hewitt v. Comm'r., 109 TC No. 12)

- a. In this case, the charitable contribution deduction was limited to the stock's basis despite the fact that there was a market for the stock; the Tax Court stated that only publicly traded stock is exempt from the appraisal requirement.

E. Use specific identification when you own several blocks of the same stock.

1. In LTR 9728021 the IRS ruled that a stock broker's plan to use a stock identification system, on instruction from clients, to sell shares with the highest cost basis first, when selling identical shares of stock, and for those shares with the same basis, to sell shares with the longest holding period, unless the client specifically identifies other shares as those to be sold, will meet the adequate identification requirements under Section 1012.

Planning Point: It is a good idea to let clients know of this ruling so that they can give similar instructions to their brokers if they wish--This is much easier than ensuring that the client remembers to specifically identify to the broker which lot of stock to sell every time when that client owns many shares in the same company and gradually sells them over time.

F. If interest rates start to rise again, use bond swaps to generate capital losses while reladdering your bond portfolio.

1. By selling the bonds at a loss, not only will you generate the capital loss but you may also be able to generate several other economic objectives:
  - a. Lengthening the call protection for your bonds;
  - b. Upgrading the quality of the bonds in your portfolio;
  - c. Improving diversification;
  - d. Switching from taxable bonds to tax-exempts; and
  - e. Extending or shortening the maturities of the bonds in your portfolio.

G. If you plan to close a short sale through delivery of shares, and you have to purchase the shares, you must leave at least three business days for the settlement of the purchase of the shares so that you will own them and be able to deliver them before the tax year end.

1. Revenue Ruling 2003-44 makes it clear that where a short position has appreciated, when the holder of the position directs the broker to purchase the shares to close the short sale, there has been a constructive sale of the short position.
- H. Beware of mutual fund distributions received in January 2009 with a record date during the last three months of 2008; those dividends are taxable in 2008.
1. Any net capital losses generated by a mutual fund do not pass through to the investor in the mutual fund in the same way that capital gains do. Instead mutual fund investors will only benefit from net losses recognized in a mutual fund to the extent the investor sells the mutual fund shares at their reduced value resulting from the losses.
  2. In LTR 9811036, the IRS has ruled that a distribution from a mutual fund that includes short-term capital gain as ordinary income is includable in a trust's distributable net income.

PLANNING POINT: Short term capital gains are reported to the investor as "dividends." However, some states, such as New York, require the trust to look behind the Form 1099 to determine what portion of the distribution is actually from ordinary income; and only that portion may be treated as DNI. The New York Estates, Powers and Trusts Law states, "Distributions made from ordinary income by a regulated investment company...are income. All other distributions made by such company..., including distributions from capital gains..., are principal." Thus, the trust document should spell out how this income is to be treated.

- I. Revenue Ruling 2008-39 provides that where an upper-tier partnership is engaged solely in the business of holding limited partnership interests in lower-tier partnerships that are engaged in the business of trading securities (a hedge fund fund of funds structure), management fees paid or incurred by the upper-tier partnership are not taken into account in computing the upper-tier partnership's taxable income or loss for purposes of determining a partner's income tax. Instead, it must be separately stated by the upper-tier partnership.
- J. The Mortgage Forgiveness Debt Relief Act of 2007 excludes discharges of up to \$2 million of indebtedness from taxation (\$1 million for a married taxpayer filing a separate return) if the debt is secured by a principal residence and if it was incurred in the acquisition, construction or substantial improvement of the principal residence.
1. This relief is available for discharges from January 1, 2007, through December 31, 2009.

- K. The Court of Claims ruled that stock acquired by a trust that owned an insurance policy in exchange for ownership rights as part of the demutualization of the insurance company had value but the value could not be determined at the time of acquisition. Thus, the trust did not realize income on the sale of the stock because the amount received was less than its cost basis in the insurance policy. The open transaction exception to Reg. Sec. 1.61-6 applied because the policyholder's ownership rights did not have a determinable fair market value at the time the policy was acquired. Eugene A. Fisher, Trustee, Seymour P. Nagan Irrevocable Trust, Plaintiff v. U.S., 2008-2 USTC ¶50,481, 8/6/08.

IV. Losses from buying and selling stocks

- A. All losses are capital (even for a trader) unless:
1. You are a dealer
  2. You make a Section 475(f) election to treat everything as marked to market and ordinary
- B. You must establish your loss to deduct it for tax purposes; even bankruptcy of the company whose stock you hold will not effectively establish the loss—you need to sell the stock.
1. Do not sell loss stock to a related party (such brothers sisters, spouses, related corporations, etc.) or the rules under Sec. 267 will get you. Sec. 267 is particularly frightening because it is a DISALLOWANCE of the loss—not just a suspension.
- C. Index options (betting on movement in a particular market) such as the S&P 100 or S&P 500 contracts are Sec. 1256 contracts.
1. These contracts are marked to market and gain or loss is treated as 60% long-term; 40% short-term capital.
  2. A loss may be carried back for three years against Sec. 1256 gains.
  3. The Standard and Poors depositary Receipt (which trades under the symbol “SPY”) is economically equivalent to the S&P 500; QQQs are traded as shares which are economically equivalent to trading the NASDAQ 100 Index option.
    - a. Both SPY and QQQ shares represent interests in unit investment trusts that are qualified for tax purposes as regulated investment companies (i.e., they are treated for tax purposes as mutual funds).

- b. The individual investor will not be subject to mark-to-market treatment but will recognize capital gain or loss for tax purposes on the ultimate disposition of the shares.
  - D. Investment interest expense is deductible to the extent of investment income.
    - 1. Investment income does not include long-term capital gain unless the taxpayer so elects—and then that gain is taxed at ordinary income rates.
    - 2. Investment income also does not include dividends taxed at the new 15% rate.
  - E. Don't donate depreciated securities to charity. You'll only get a deduction for fair market value.
  - F. In Revenue Ruling 2002-66, the IRS made it clear that stock and a position that collars the stock will be deemed one big straddle. Such a holding results in several negative tax consequences to the collar investor:
    - 1. Where the positions in the stock and its collar are part of a larger straddle, any loss realized from closing one leg of the straddle must be deferred to the extent there is any unrealized gain in an open leg.
    - 2. Any interest expense incurred to carry any position in the larger straddle must be capitalized, rather than being currently taxable.
- Planning Point: Any losses recognized on positions in a collar will only be available for tax purposes to the extent there is no remaining unrecognized gain in the collar position.

- V. Section 475(f) allows a securities or commodities trader to make a binding election to use the mark-to-market method of tax accounting and treat all gain and loss resulting from this election as ordinary.
  - A. The gain or loss is recognized as if the securities were sold for their fair market value on the last business day of the taxable year.
  - B. An exception to the mark-to-market rule is available if a same-day identification is made with respect to a security that is not part of the trading activity and if the taxpayer can establish that the security has no connection with the taxpayer's activities as a securities trader.
    - a. The §475(f) election must be made by filing a statement no later than the original due date of the federal income tax return for the taxable year *immediately preceding* the election year.

- i. The statement must be attached to either the return (if filed without extension) or to a request for an extension of time to file the return.
  - ii. An election to be treated as a securities trader under §475(f) for the calendar year 2009 must be filed on or before April 15, 2009.
  - iii. A taxpayer who was not required to file a federal income tax return for the taxable year immediately preceding the election year (a new taxpayer) must make the election by placing in its books and records no later than two months and fifteen days after the first day of the election year an election statement.
    1. To notify the IRS that the election was made, the new taxpayer must attach a copy of the statement to its original federal income tax return for the election year.
  - iv. The election statement for either existing or new taxpayers must describe:
    1. the election being made;
    2. the first taxable year for which the election is effective; and
    3. the trade or business for which the election is made.
- b. All taxpayers making the §475 election (other than new taxpayers) must file a Form 3115 requesting a change in accounting method.
- i. The Form 3115 must be attached to the taxpayer's timely filed (including extensions) original federal income tax return for the year of change.
  - ii. A copy of the Form 3115 must be filed with the IRS National Office no later than when the original Form 3115 is filed with the federal income tax return of the year of change.
  - iii. As a result of Rev. Procs. 2002-18 and 2002-19, any unrealized losses marked to market at the beginning of the year of change will all be recognized in the year of change.
- c. Who should make the mark-to-market election?
- d. For what accounts should the election be made?
- C. In William G. Holsinger et ux. v. Commissioner (T.C. Memo. 2008-191; No. 15563-06, 8/11/08), the Tax Court recently ruled that a taxpayer who had incorporated an entity that made a Section 475 (f) election did not qualify for the election because the level of trading was not significant enough (the taxpayer

traded on less than 45 percent of the available trading days) and a significant amount of the positions were held for more than 31 days.

## VI. Hedge Funds

- a. Like mutual funds, hedge funds are pooled investments; however, the similarity ends there.
  - i. The largest hedge funds are only a few billion in assets whereas some mutual funds have more than \$100 billion in assets.
  - ii. Mutual funds are highly regulated and open to any investors; Hedge funds are unregulated and are only open to accredited investors—defined by the SEC as individuals who have a net worth of \$1 million or who have had net income of \$200,000 in each of the past two years and who have reasonable expectations of continued income at that level.
    1. The limit on the number of such investors is 100.
    2. Such funds are also known as Section 3(c)(1) funds.
- b. A “super accredited” fund is one where all of the investors are **qualified purchasers**—trusts, natural persons, or family-controlled companies that own not less than \$5 million in investments; and any person acting for his or her own account or that of other qualified purchasers, who owns or invests on a discretionary basis not less than \$25 million.
  - i. Such funds can accept up to 500 investors.
  - ii. These funds are also known as Section 3(c)(7) funds.
- c. Mutual fund managers are prohibited from using derivatives or selling short; hedge funds can use any type of trade to achieve results.
- d. Mutual fund managers are paid based on assets under management; hedge fund managers are paid for performance.
- e. Hedge funds often use significant amounts of leverage.
- f. A domestic hedge fund is generally a limited partnership structured to give the managers who are the general partners a share of the profits and losses.
  - i. This share is known as the performance fee and is almost always 20%.
  - ii. There is also almost always a management fee equal to between 1 and 2%.

- iii. There is generally a provision for a “high-water mark”—a clause in the partnership agreement that says if the fund loses money, the manager will not be paid the incentive fee until it recoups the partners’ losses.
- g. Trader partnerships allow the partners to deduct the expenses of the fund above the line; while investor partnerships do not.
- h. Hedge funds are not tax efficient—and investors can be surprised by the annual tax results due to issues such as wash sales and investment interest expense.
- i. Key investment partnership documents include the offering document (the private placement memorandum—PPM) and the limited partnership agreement.
- j. Lock-up Provisions
  - i. The lock-up period will generally be anywhere from one to three years.
- k. Break Periods
  - i. The break-period represents the time at which the hedge fund investor can withdraw money from the fund (once the lock-up requirements have been fulfilled).
- l. Fund of Funds
  - i. In a fund of funds, the fund manager invests in other money managers or funds that may invest in a diverse array of securities and in a number of different styles to create a diversified portfolio of hedge fund investments.
  - ii. In a fund of funds, not only do the underlying hedge fund managers take fees but so does the fund of funds manager.
- m. Tax-exempt Investors
  - i. Unrelated business taxable income (UBTI) results from debt financing. (Section 514)
  - ii. ERISA investors must be limited to avoid the need for compliance with certain ERISA regulatory requirements.
- n. Offshore Funds
  - i. Offshore funds (established in places like Bermuda and the Cayman Islands) are formed as corporate structures to house foreign and tax-exempt investors.

- ii. Offshore funds have been used by the hedge fund manager as an opportunity to defer fee recognition through nonqualified deferred compensation arrangements.
- o. Master/Feeder Funds
  - i. These are two-tiered structures in which investors invest in a “feeder” fund which feeds the investment capital to a “master” fund managed by the same investment adviser.
  - ii. The master fund is the entity that actually invests in the market.
- p. The partnership agreement will generally provide that, where a partner requests a partial withdrawal, the fund can require that the partner fully withdraw where the withdrawal reduces the partner’s investment below a certain level.

## VII. Tax Traps in Betting on Market Movements

- A. It is now possible to trade instruments that track the movement of a variety of different markets and sectors of the market. For instance, if you wish to benefit from an upward move in the S&P 500, you could purchase either the S&P 500 index option or the Standard & Poors Depository Receipt (which trades under the symbol “SPY”). You can bet on upward movements in the NASDAQ by acquiring either the NASDAQ 100 Index option or QQQ shares.
- B. While the economic results of either a direct investment in the index option or in SPY or QQQ shares (depending on which index you are trading) may not be all that dissimilar, the tax consequences of such trading are vastly different.
- C. Index Investing
  - 1. Investment in an option on a broad-based stock index constitutes investment in a regulated futures contract (RFC). Under Section 1256 of the Internal Revenue Code, RFCs are taxed on a mark-to-market basis at year-end. Any resulting gain or loss (or any gain or loss on the actual disposition of the RFC) is taxed as 60% long-term and 40% short-term capital gain or loss. Both the S&P 500 and the NASDAQ 100 are broad-based stock indexes and therefore subjected to mark-to-market treatment for anyone other those who deal in the options.
  - 2. Individual taxpayers who have unused losses from Section 1256 contracts in the current year may carry those losses back to each of the three prior tax years and net the losses against any net gains from Section 1256 contracts (to the extent there was actually net capital gain in the earlier tax year). The taxpayer may choose whether or not to elect this treatment.

E. Share Investing

1. Both SPY and QQQ shares are Exchange Traded Funds (ETFs). They represent interests in unit investment trusts. Such trusts are qualified for tax purposes as regulated investment companies (i.e., they are treated for tax purposes as mutual funds). Thus, the individual investor will not be subject to mark-to-market treatment but will recognize capital gain or loss for tax purposes on the ultimate disposition of the shares. The gain or loss on the shares will be treated as long-term if the shares have been held for more than one year. Otherwise, it will be short-term.

F. Commodities Investing through Shares

1. Ownership in gold can now be purchased through a grantor trust structure called Streettracks Gold Shares (symbol GLD). These shares represent fractional interests in the trust and income and expense items flow through to holders so that they are treated as if they own a pro rata share of the underlying assets.
2. When the trust sells gold, the holder recognizes his pro rata share of the gain or loss for tax purposes. If it is a long-term gain, it is taxed at the 28% rate imposed on collectibles (not the 15% rate imposed on common stock shares).

G. Narrow-Based Security Indexes

1. The Commodities Futures Modernization Act of 2000, enacted at the very end of 2000, redefined the index options that are treated as “narrow-based” (and, therefore, not subject to Section 1256 treatment). While the definitions contained in the Act are relatively detailed and technical, it is important to keep in mind that certain index options that had previously been treated as narrow-based (e.g., SOX options) were recharacterized to broad-based.

VIII. Trading in Distressed Debt

- A. Deeply discounted debt may come with both original issue discount (OID) and market discount.
- B. OID is the excess of the stated redemption price at maturity over the issue price of an instrument.
  1. Section 1272 requires current inclusion in income of a ratable portion of OID.

2. Under tax common law, an accrual method taxpayer can stop accruing interest on a debt holding if there is no reasonable expectation of collection of the debt.
  3. TAM 9835007 states that the case law does not apply to OID accruals.
- C. Market discount is the excess of the face amount of a debt instrument over the taxpayer's basis in the debt.
1. Market discount accrues on a straight-line basis over the remaining life of debt unless a taxpayer elects constant yield accrual.
  2. Gain on the sale or retirement of a debt instrument is treated as ordinary income to the extent of the accrued market discount.
  3. Under a literal application of the market discount rules, if distressed debt with a face of \$100 was purchased for \$40 with two years to maturity and the debtor paid \$20 after one year, that entire amount would be considered ordinary income.
- D. What happens when payments are made related to distressed debt that has been acquired by the taxpayer?
1. Several old Tax Court cases would indicate open transaction accounting for "speculative investments." (see *Underhill, Liftin*)
  2. 1994 OID regulations state that all payments are treated first as interest to the extent accrued, then as principal.
  3. Is gain or loss on sale of instrument capital or ordinary?

IX. American Depositary Receipts (ADRs)

- A. ADRs represent ownership in the underlying shares of a foreign company.
1. Prices are quoted in U.S. dollars.
  2. Dividends are payable in U.S. dollars.

X. Taxation of Options Transactions

- A. Long calls

1. If a call option is acquired by the taxpayer, the tax treatment on its disposition will be determined by whether it is sold or exercised. Upon sale, if the call was held for more than one year, any gain or loss will be long-term and capital. If the call was held for one year or less, any gain or loss will be short-term and capital.
2. Expiration of a call is treated the same as a sale of the call.
3. Exercise of a call results in capitalization of the premium that was paid for the call, along with the brokerage commissions paid both on acquisition of the call and exercise of the call, into the basis of the stock that is acquired through exercise of the call. The holding period of the stock so acquired begins on the day after the date the call is exercised (and does not include the holding period of the call).

B. Short calls

1. The writer of a call does not recognize the premium received for the call option as income at the time of receipt. Instead, that amount is held in suspense until the writer's underlying obligation to deliver stock pursuant to the terms of the call option is, in some way, eliminated--either the call lapses or the writer sells the underlying stock as a result of the exercise of the call or the call is terminated in some other way than by lapse or exercise.
2. If the writer's obligation lapses, the premium is short-term capital gain, regardless of the length of time the call is outstanding.
3. Where the writer terminates the call other than by lapse or delivering stock on exercise of the call, the gain or loss on the termination will always be short-term gain or loss, regardless of the period of time the call was outstanding.
4. However, where the call is exercised, the strike price paid for the stock by its purchaser, plus the premium received for writing the call, constitutes the total sales price for determining gain or loss on the stock. If the holding period for the underlying stock is long-term when the call is exercised, the total gain or loss will then be long-term (assuming the straddle rules, discussed later) do not apply.

C. Long Puts

1. An acquired naked put that is sold any time prior to exercise results in capital gain or loss that is either long-or short-term, depending on the holding period of the put.

2. Where a naked put is allowed to lapse, the gain or loss is again long- or short-term, depending upon the holding period of the put prior to its lapse.
3. If the put is exercised, the premium paid for it, along with the commission paid on the sale of the stock to which it relates, both reduce the amount realized on the sale of the underlying stock.
4. If the put offsets an underlying long-term stock holding, any loss recognized on disposition of the put will always be long-term.
5. Determining whether the gain or loss on the sale of the underlying stock is long- or short-term is tricky in the case where an offsetting put has been acquired. The acquisition of a put is a short sale. When a short sale is entered into with respect to underlying stock that has been held for one year or less, the holding period in that short-term property is *destroyed*. Thus, once the put expires or is exercised, the holding period of the underlying stock begins again at day one. However, if the holding period of the underlying stock to which the put relates is already long-term before the put is acquired, then the gain or loss on the sale of the underlying stock would remain long-term.

#### D. Short Puts

1. The premium received for writing a put is held in suspense just like the premium for writing a call until the writer's obligation is terminated.
2. If a put is permitted to expire, the premium amount will always constitute short-term capital gain.
3. Where the put is exercised, the strike price specified in the put, along with the commission paid to purchase the stock, is reduced by the premium received for writing the put to compute the total cost basis in the stock acquired as a result of the put being exercised. The holding period for the stock so purchased begins on the day after the date the stock was purchased.

#### E. Qualified Covered Calls

1. Qualified covered calls that offset an underlying stock position are not considered to constitute a straddle because the taxpayer's risk of loss with respect to the underlying stock will not be substantially reduced. However, a "deep-in-the-money" call will substantially reduce risk and will result in a straddle.
2. A qualified covered call is a call option that

- a. is exchange-traded;
- b. is written by the investor on stock that is held by him or acquired by him in connection with writing the call;
- c. has a term of longer than 30 days;
- d. will result in capital gain or loss to the investor; and
- e. has a strike price that is not lower than the lowest qualified benchmark for that option.
  - (i) The lowest qualified benchmark is generally the highest available strike price for such option which is less than the applicable stock price of the underlying stock. Generally, the applicable stock price is the closing price of the optioned stock on the most recent day such stock was traded before the date on which the option was written. However, if the opening price of the optioned stock on the day the option was written is greater than 110% of the closing price on the last previous trading day, the applicable stock price is the opening price.
- f. Where the strike price of the qualified covered call option is less than the applicable stock price, any loss with respect to the option will be treated as long-term capital loss if, at the time the loss was realized, gain on the sale or exchange of the stock would be treated as long-term capital gain. Furthermore, writing such a qualified covered call will result in the suspension of the holding period for the underlying stock during the time the qualified covered call is open.

#### F. Collars

1. An IRS private letter ruling concludes that the put option and the long position in the underlying stock in a collar transaction constitute a straddle. Additionally, it states that the call option and the long position constitute a straddle. (However, in order for a straddle to exist, the offsetting option position must serve to substantially diminish the risk of loss from holding the underlying option position. Determining whether this substantial diminution of risk has taken place is where there is room for argument that some collars will not result in sufficient risk reduction to constitute a straddle.)
2. Assuming the straddle rules do apply, the taxpayer must identify which shares of his long position are part of the straddle in order for all substantially identical shares he owns not to get swept up in the straddle rules. In the private letter ruling, the IRS concluded that it is permissible for taxpayers to identify which shares of stock are part of a straddle, where more than enough of the stock is owned to satisfy the number of shares specified in the collar. Furthermore, the IRS stated that because the

exercise price under the call option will be higher than the exercise price under the put option, it is certain that at most one of the options will be exercised at maturity. Thus, the shares that are collateral for, or otherwise identified with, the call option may also be identified with the put option. These identifications must be made at the time the collar is entered into.

#### G. Wash Sale Rules and Options

1. As noted earlier, the sale of a security at a loss followed within 30 days by the purchase of a call option for the same security (or preceded within 30 days by the purchase of such a call) will constitute a wash sale so that the loss is disallowed for tax purposes until the taxpayer has finally sold out of the substantially identical position and remains out of it for more than 30 days.
2. However, the reverse is not true. The wash sale rules do not seem to apply to the sale of an option at a loss followed or preceded by a stock purchase. The underlying reason for this conclusion is that the holder of an option position would be required to make a substantial added investment to acquire the stock and is, therefore, not in the same investment position as the holder of the stock. This reasoning starts to break down as the option gets deeper in the money and might be problematic where the cost of the option is substantial.
3. Where a taxpayer sold stock at a loss and, within the wash sale period, sold a put option with a strike price making it extremely likely that the put would be exercised and the taxpayer would be contractually obligated to purchase substantially identical stock, the IRS ruled that the wash sale rules applied.
4. The wash sale rules also apply to the closing of a short sale if, within 30 days before or after the closing, substantially identical stock or securities are sold or the taxpayer enters into another short sale of substantially identical stock or securities. The issue that is unresolved here is what constitutes “substantially identical?” In options trading, how different do the strike prices and maturities need to be to fall outside the parameters of substantially identical?

#### H. Conversion Transactions

1. Where the taxpayer is, in reality, in the economic position of a lender, a transaction that seeks to convert that interest rate of return into capital gain or loss is deemed a “conversion transaction.” In such transactions that interest rate of return is recharacterized under the tax law as ordinary income rather than capital gain.

