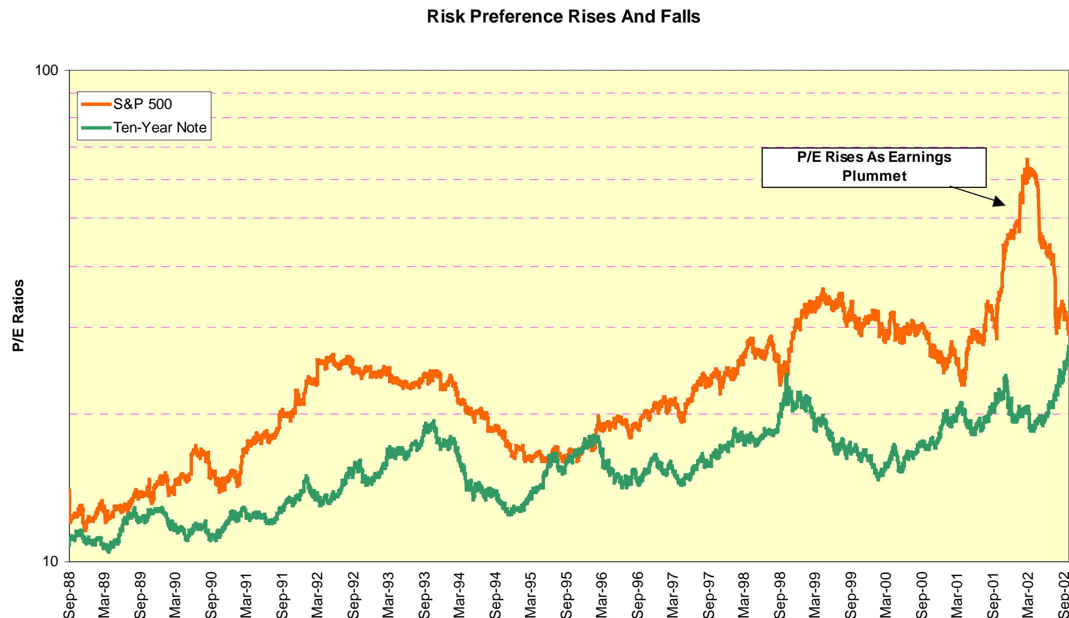
Death, Taxes And Single Stock Futures

How many times have you agreed to disagree with your fellow traders and topped off the conversation with "That's why we have a market!" There's a lot more to this bon mot than is apparent on the surface: If a consensus emerged on the value of any given asset, trade therein would collapse toward zero. It is precisely those commodities whose value either fluctuates violently or is so hard to determine by even the most honest and well-intentioned analysts amongst us that enjoy active trade.

Bigger Tools For Greater Fools

Let's make a bold statement: Stocks are categorically impossible to value on a fundamental basis. How so? Even if we had perfect knowledge of both the firm's future earnings stream and interest rates, we still would be left in the dark about what P/E multiple the market will assign at any given time. These multiples can take on any value as traders become more or less risk seeking.

If capital markets are operating efficiently – and we're supposed to say they do – the risk-adjusted multiples of stocks and bonds should be equal. The implied multiple of a bond is the reciprocal of its yield, and this can be compared to stocks' P/E multiple. Ideally, we would make this comparison not on current earnings, but rather on the contemporaneous forecast of earnings.



The difference between the two markets' multiples is known as the equity risk premium; during the height of the late 1990s bull market, James Glassman and Kevin Hassett argued this risk premium should be zero and therefore the Dow Jones Industrials should be trading at 36,000. Those are U.S. dollars, not Argentine pesos. Unlike the fabled Seventh Cavalry, the Greater Fool regiment failed to ride to the rescue in March 2000. Custer would understand what happened next.

Stocks owe their trading volume to this uncertainty. Paradoxically, since stock volatility rises when prices fall, the volume of stock index derivatives jumps in downturns, leading many in the industry to confuse a bear market for brains.

Add Confusion, Stir Gently

If valuing equities is impossible, what would happen if we created a tax environment that forced different traders to value a given contract differently? The answer in mathematical terms would be a problem

without a single or “closed-form" solution. This is hardly unusual in markets; foreign exchange is characterized by a single equation with three unknowns, the two interest rates and the spot exchange rate. As a result, any spot rate or any single interest rate can clear the market for some trader, and the multiple possible combinations of valid prices create enormous trading volume.

Single stock futures (SSFs) are securities as well as futures. Unlike conventional securities, however, they have expiration cycles, uses for hedging and forward pricing purposes, and a basis to the price of the underlying stock. Each of these attributes of futures has its own tax treatment, as anyone who has wrestled with the complexities of FAS 133 will attest. A reconciliation of the separate tax treatments for the two instruments was required.

It is best to acquire a certain frame of mind to deal with tax issues. The logical approach of what may make economic sense likely will be unproductive. Tax law is built from the bottom up, not from the top down; each section of the massive tax code accreted to existing treatments through the efforts of some determined interest group.

A case in point here, as an example of illogic, is the distinction between long-term and short-term capital gains. Why should the tax code reward those who hold a position for more than a year? Does holding a moribund asset for a longer period of time constitute virtue, and conversely are market makers who trade frequently and provide liquidity to the market somehow evil? The holding period of any asset should be irrelevant: If the purpose of a market is to allocate capital efficiently, any and all impediments to free trade suppress the disposition of price information and therefore lower liquidity and increase volatility.

Taxes Create Risk

In general, the tax code is keyed to realized accounting gains irrespective of unrealized economic gains. Let's take two transactions that produce the same economic gain:

1. Buy a stock at $35, watch its price rise to $45, sell a SSF at $45. If the stock continues rising, say to $50, you buy the SSF back at a $5 loss that can be used to offset gains elsewhere up to the $3,000 limit. The unrealized capital gain on the stock of $15 remains untaxed and at risk. Economically, the pre-tax net gain is $15 - $5, or $10.
2. Buy a stock at $35, watch its price rise to $45, sell a SSF at $45, and then deliver the stock against the future at $45. You now have a realized short-term capital gain of $10 taxable at your ordinary income rate but no further risk on stock.

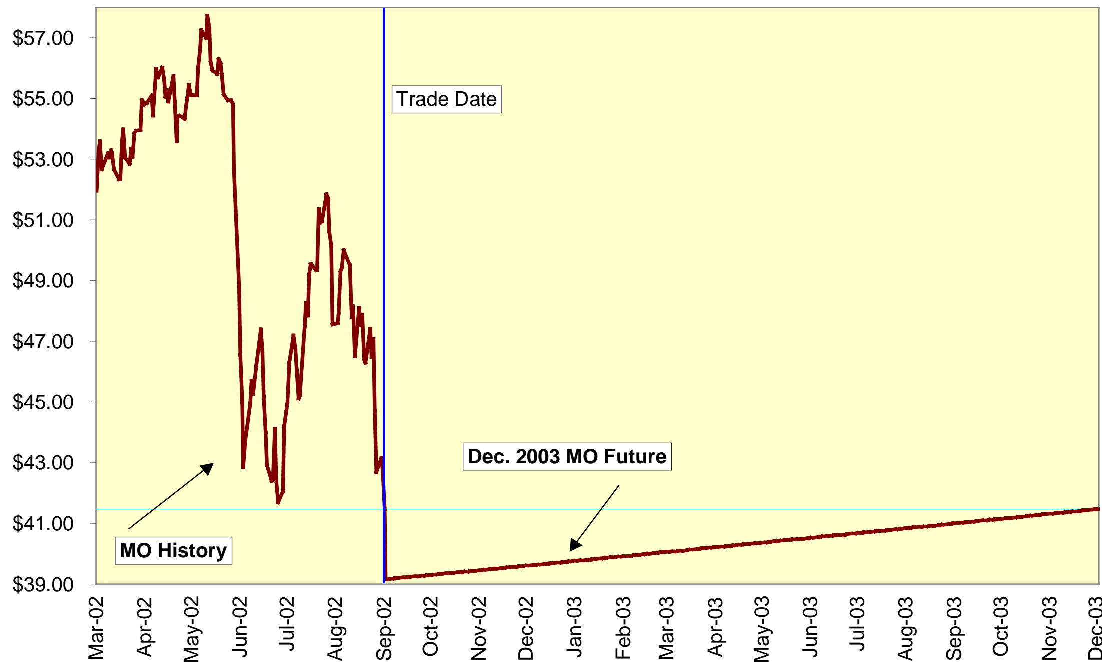
Which alternative is preferable? You have no way of knowing beforehand. We do know, however, that the cultural bias is to buy-and-hold, which means keeping the $15 unrealized gain at risk and harvesting the $5 loss. If this stock does not pay a dividend, its effective duration is quite long – you never receive any income or return of principal until you sell – which raises the overall risk level for stock ownership. This behavior is akin to betting your entire stake each hand in a poker game, something not recommended anywhere.

The Fifth Quarter

For non-dealers, which includes just about all individual traders and who will be the subject of all further discussion below, Section 1234 of the tax code calls for SSFs to be taxed as capital gains. While any long position in a SSF held more than a year (only Nasdaq Liffe Markets has a fifth-quarter contract) will receive long-term capital gain treatment, all short positions always will be taxed at the short-term rate. Why? Because the tax code wants to reward investors, not traders, and the thinking is that a short position cannot be an investment.

This seemingly innocuous provision assures us that different traders will value this fifth-quarter contract differently. First, the long will be taxed at a lower rate than the short for an equal holding period. Second, the short-term capital gains rate will differ among short traders as each individual's effective short-term rate is a function tax bracket, net capital gain and loss including carryovers, and dozens of the other factors that make tax time such fun. Third, if the underlying stock pays a dividend yield greater than the short-term cost of capital, the SSF will trade at a discount to the stock. In a static or rising price environment for the

stock, the accrual of this discount will turn the ordinary income of the dividend payments into a long-term capital gain, as illustrated with Philip Morris and its 6.17% dividend yield at the time of this writing. For simplicity's sake, the dividend payout is depicted as continuous rather than in discrete quarterly payments.



For this ability to capitalize a dividend payment, the long in a fifth quarter contract should value the contract more than the short. In addition, the short faces the same problem faced by shorts in interest rate contracts, the constant upward accrual for SSFs on dividend-paying stocks in a static or rising price environment.

The tax implications change for declining stock prices. The long still receives the accrual, which is paid by the short, but the net position will now show a long-term capital loss. The economic value of this loss, and of the short's gains, will differ from trader to trader depending on their other capital gains and losses.

End Of The Blend

Futures traders are used to receiving a blended rate on their taxes of 60% long-term and 40% short-term under Section 1256. That's right, those of you flipping e-mini Nasdaq 100 contracts ten times a day get the lower long-term rate on 60% of your gains, and you get it regardless of whether your gains derived from a long or a short position. So much for the internal logic of the tax code.

A downside of Section 1256 that won't apply for SSFs is futures traders having to pay a tax on their open equity as of December 31st of each year. This stems from the glory days of the 1970s when neophyte traders could turn a quick hundred grand in cattle futures. How? You went long in Account A, short in Account B, booked whichever account showed a loss by year-end and then took your gain in early January, thereby deferring the tax liability. You don't tug on Superman's cape: The tax law was amended to make you pay tax on the still-open profitable account.

What Is A Hedge?

Under Section 1259, the sale of a SSF against the underlying stock constitutes a constructive sale unless it comes under these two requirements for a short-term hedging exemption:

- The hedge must be closed before the 30th day after the close of the taxable year, which will be January 30 for most of us; and
- For 60 days after closing the hedge, the underlying stock cannot be sold, nor can a new hedge be emplaced

In other words, someone who wants to hedge an appreciated security for whatever reason has to be unhedged on the position for 60 days each year in order to qualify for the hedge exemption.

Remember the January Effect? Get ready for the February-March Effect: The closing of short SSF hedges against appreciated securities will put buying power into the stock, and the tax incentive to hold the stock for another 60 days will support the stock over that period. Then we might see some April showers as either new short positions are emplaced or the stock itself is sold.

Other Tax Considerations
The wash sale rules of Section 1091 will apply. If you buy a SSF within thirty days of selling the underlying stock at a loss, you won't be able to book the loss for tax purposes. If you deliver a stock at a loss against a short SSF position, and then buy the same stock back within 30 days, the loss cannot be booked for tax purposes.

Under Section 1223(16), if a security is received in delivery against a long SSF, the holding period for tax purposes begins at the SSF purchase date. This is a definite advantage of over the treatment for stock options, where the option holding period is ignored.

The Bottom Line
If you are confused, take solace that Albert Einstein hired an accountant to do his taxes. They are not designed to be simple or logical, and we can be assured that they rules will change and change frequently. If your objective is to trade, then don't let taxes get in the way of your trading. Trading decisions made for tax purposes often are regretted.

It is important to remember that terrain determines tactics. An understanding of how tax law creates trading opportunities for SSFs, especially for the fifth quarter contract, will provide you with an edge in the market, and what more can you ask for?