Tax And The Single Stock Future

"Nothing is certain but death and taxes" - Benjamin Franklin

Death and taxes may be of equal certainty, and both create employment for legions of lawyers and accountants, but at least death is easy to understand. Get in a long tax discussion with Lucifer and you'll so confuse the Prince of Darkness that he might forget the initial purpose of your visit.

Single stock futures, (SSFs) like so many financial products before them, will trade in an environment sculpted by tax law. As with everything else associated with these seemingly simple contracts, the reconciliation of how we tax futures and how we tax equities has been anything but simple. But, savvy traders and financial planners know this creates nothing but opportunity.

Two, Two, Two Taxes In One
The first key to understanding SSF futures is recognizing they are securities as well as futures. Unlike conventional securities, however, they have expiration cycles, uses for hedging and forward pricing purposes, and a "basis," or premium/discount to the price of the underlying stock. These attributes of futures have their own tax treatment and these required changes to the existing tax laws for dealers, market makers and futures traders.

The second key is acquiring a certain frame of mind: Taxes are not supposed to make sense, they are supposed to pluck feathers from designated chickens and occasionally reattach the plumage elsewhere. A case in point here, if I may digress, 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? If the purpose of a market is to allocate capital efficiently, this incentive not to trade suppresses the disposition of price information.

Who is helped by holding onto a moribund, but still-appreciated asset just to obtain a lower tax rate? This makes about as much sense as creating a separate pricing and regulatory regime for long distance, as opposed to local, telephone carriers.

Oh.

Taxes Create Risk
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.

Terrain Determines Tactics
For non-dealers, which includes just about all individual traders and who will be the subject of all further discussion below, §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.

Under §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.

Futures traders are used to receiving a blended rate on their taxes of 60% long-term and 40% short-term under §1256 (the tax code has more sections than a bag of navel oranges). 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 §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.

The Big "Huh?"
And now, like the Rolling Stones' *Honky Tonk Woman*, here's something to blow your mind. Under §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. They do have fun in that parallel universe, don't they?

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.

A Wash-Day Miracle
The wash sale rules of §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.

A number of other tax rules have been created for corporations and dealers. The complexity for non-dealers is enough. At least we can take solace that once tax law is written, they pretty much leave it alone, don't they?