

Harvesting losses with options

There are ways to take losses with minimal disruption to alpha

By Robert N. Gordon

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Investors and their advisers are rightfully concerned about running afoul of the wash sale rule and triggering a taxable event. As you know, a wash sale — as defined in Section 1091 of the Internal Revenue Code — occurs when an investor sells property at a loss and within 30 days acquires "substantially identical" property.

Unfortunately, the government's definition of "substantially identical" is not crystal-clear, leading many transactions to come under the wash sale rule despite the best intentions of advisers and investors.

Consider one options play intended to work within the wash sale rule — the sale of a put option after shares are sold for a loss. This strategy can be more useful this year because of extreme volatility; when volatility is high, so too are any put option premiums.

Let's say Jane Investor sells ABC at \$100 for a loss. She then receives \$9 for selling an at-the-money put with a strike price of \$100 expiring 31 days (or more) from now.

Jane plans to repurchase ABC at option expiration either through the option's exercise or open-market purchase of ABC shares.

Internal Revenue Service Ruling 85-87 states that if an investor sells stock for a loss and within 30 days sells a put option, the sale of the put option could trigger the wash sale rule. The rule allows for the sale of puts only if they are not "likely to be exercised."

Because there are no guidelines for this "not likely to be exercised" standard, most practitioners advise the writing of puts that are either at or out of the money. They would advise that Jane sell puts with a strike price of \$100 or below with ABC trading at \$100.

The more Jane receives for selling puts, the more her performance will keep pace with ABC common. Performance will be affected only if ABC grows to more than \$109 in the requisite 31 days. The more money received for the put options, the more confident Jane can be that she won't miss appreciable ABC stock growth.

Another option strategy to stay invested but still stay within the wash sale rule actually calls for purposely failing the test before repurchasing any shares.

If an investor sells a stock for a loss and buys a call option (within the 31-day window) the wash sale rule is triggered. This applies to any call option. I agree with the law that the purchase of a very deep in-the-money call might act "identically" to the stock, but certainly not an out-of-the money call option.

It might make more sense if the wash sale rule applied only when there were a high likelihood of the calls' being exercised, such as in the language used in the put example.

The penalty for a wash sale is the deferral of any capital loss that has been realized. Again, the capital loss is deferred, not lost, and the deferred loss increases the cost basis of the recently purchased property.

Let's say Jane Investor purchased ABC for \$130 a share two years ago. On Nov. 7, she sells ABC for \$100 and soon after buys a call option on ABC for \$6. In this example, Jane now owns a call option worth \$6 that has a cost basis of \$36.

When the call is sold, a loss could occur if the value is less than \$36. Of course, this loss could be caught again by the wash sale rule.

But it is harder to trigger the wash sale rule from exiting option positions. Ironically, the subsequent purchase of shares does not trigger the wash sale from losses on options (Ruling 58-384). I know this asymmetric treatment is not logical, but it is the law. Therefore, Jane can buy the ABC shares back in less than 31 days as long as she buys a call option on ABC between the two transactions.

To summarize the technique: 1) Sell stock for a loss; 2) Buy a call option that triggers the wash sale rule; 3) Buy back the shares that were sold earlier for a loss.

Alternatively, there are those who throw in the towel and give up on shares with losses. Here too, options may be useful. In the example above, Jane had \$30 of unrealized long-term losses. If she possessed both short-term gains and long-term gains, she would find much more value in a short-term loss than in a long-term loss.

As in the prior strategy, Jane sells her shares for \$100, buys a call option on ABC and triggers a wash sale. But instead of selling the calls, she wants to exercise the calls and start a new holding period.

After exercising the calls and buying ABC again, she can sell the shares for a short-term loss instead of the long-term loss that would have occurred had Jane simply sold her ABC shares or her ABC call options.

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