

## The tax impact of selling calls

The sales can bring in good money, but watch out for tax traps

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Selling covered calls is a common strategy employed by many investors to enhance the return of their equity position.

In today's high-volatility, directionless market, this strategy has become quite attractive. Yet many investors with low-basis stock are hesitant to sell covered calls for fear of the complications they might face.

While the tax consequences of a wrong move are numerous, they can be managed and effectively eliminated.

One problem area involves the Constructive Sale Rule in Section 1259 of the Internal Revenue Code. The rule states that transactions that take an offsetting position to an already owned profitable position are considered to be sales — and subject to capital gains tax.

In the case of selling covered calls, a taxable sale can be triggered if the calls are so deep in the money that their exercise is almost assured.

There are no rules on just how in the money a call's strike price can be, but traders look for a clue in the option's delta or the predicted sensitivity of the option's price relative to a change in the price of the underlying asset.

Too high a delta — instances where the option tracks the stock almost 1-to-1 — could trigger a gain.

Selling calls also can affect the taxation of dividends. In this area, investors should be aware that they are the policemen of their own behavior. Investors have the responsibility for paying the correct tax on dividends, even when a broker sends a 1099 form stating that a received dividend is qualified for the preferential 15% rate.

It might not be.

As an example, when an investor buys any put, the dividend holding period is "blown." This surprises many investors, who may have held the shares for years. Most know about the 61-day holding period required for dividend qualification, but few are aware that a holding period test must be performed every

record date. Owning a put automatically cancels the holding period (but only for dividend period measurement, not necessarily the long-term or short-term holding period).

Selling a qualified covered call does not affect a dividend's taxation. To qualify, the call cannot be in the money, and the time until expiration must exceed 30 days yet not go beyond 33 months. The call not only must be out of the money but also must be further and further out of the money as the calls extend over 12 months. Our website offers a calculator to assist investors in this calculation.

Some investors with low-basis shares worry about selling covered calls, because they fear being forced to deliver stock if a call is exercised, and then being hit with a hefty tax bill because the shares are low-basis.

This need not be the case.

To reap all the rewards of selling covered calls without ever delivering their low-basis shares, investors can sell European-style calls. Unlike American-style standard listed options, which the option holder can exercise at any time, European-style options are exercisable only at maturity.

European Flex (for flexible-exchange) options, which are traded on the options exchanges, can be created for virtually any stock on which listed-options trading already takes place. Like their standard counterparts, Flex options are backed by the AAA-rated Options Clearing Corp. of Chicago.

To create these options, though, the notional amount covered must exceed \$1 million (or 25,000 shares, whichever is less). If these options are European-style, the covered-call seller can simply buy them back at any time before expiration, thus insuring that shares are not delivered if the stock is above the strike price.

While using Flex options on low-basis shares may be ideal, an investor can use standard Americanstyle options and still avoid delivering low-basis shares if a call is exercised. Instead of delivering their low-basis shares, investors can simply buy shares in the open market and deliver those shares against the assigned call. This way, low-basis shares are not delivered, thus not triggering the large capital gains tax.

In today's environment, covered-call writing can contribute a more significant portion of returns than it has in years past.

If owners of low-basis shares are able to write covered calls without fear of share delivery, they can earn higher returns with greater peace of mind.

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