Getting Back to Basics: Securities Analysis and Section 475 Elections

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In the dynamic world of financial markets, investors and traders employ various strategies to maximize returns and manage risks. However, these strategies often come with complex (at times, costly) tax implications that can significantly affect the taxable income reported. Understanding the common tax adjustments that arise from trading in the financial markets (e.g., wash sales, straddle adjustments, constructive sales) and the methods to remedy or control the amount of the adjustments are key to a tax-efficient trading strategy.

Wash Sales

Wash sales are the most common adjustments that any investment or trade may be subject to when closed. As defined in §1091, a wash sale occurs when a position in a security is closed at a loss. Then, a “substantially identical” security position is opened within a 61-day window, encompassing 30 days before and after closing the loss position.

The IRS does not spell out precisely what makes one security substantially identical to another but states that taxpayers must consider all relevant facts and circumstances. Generally, two companies' stocks would not be substantially identical, except in the event of a reorganization. In addition, stocks and bonds issued by the same company generally would not be substantially identical, unless the bonds are convertible. However, “substantially identical” securities do include contracts or options to acquire stock or securities, including cash-settled contracts. Cryptocurrencies are not, as of the date of this article, subject to the wash sale rules; however, legislation has been proposed to address this.

A wash sale adjustment aims to prevent investors from (1) claiming tax losses without materially altering their investment position or (2) creating artificial tax losses in situations where the intent is not to reduce the position in the securities that have been sold. When a wash sale is identified, the loss is deferred for tax purposes. The loss is added to the basis of the tax lot or position that triggered the wash sale within the 61-day window. The holding period of the "washed" loss is tacked onto the holding period of the new position per §1223(4).

Strategies are available to remedy or potentially use a wash sale to one's advantage. Some of these strategies include doubling up on the position; doubling up and selling call options; selling the stock and selling puts; doubling up on the stock and selling calls and buying puts; and, lastly, if a short sale triggered the wash sale, closing the short sale and buying a put option. However, many of these remedies expose the taxpayer to the potential for additional losses that should be considered.

Wash sales can convert a long-term loss (offsetting other gains at the beneficial tax rates) into a short-term loss (offsetting other gains at the higher ordinary rates). To do this, the taxpayer would first sell the stock and recognize the long-term capital loss. Next, within the 61-day window (or 30 days after the stock sale), the taxpayer would purchase a call option on the same stock, which triggers a wash sale. Then the taxpayer exercises the call option and sells the stock received through the exercise of the call. Because the exercise of the call option starts a new holding period of the stock, the result is a short-term capital loss instead of a long-term capital loss.

Straddle Adjustment

A second securities adjustment common in the trading and investment world is a straddle adjustment under §1092. A straddle involves holding offsetting positions on personal property, such as stocks or commodities, significantly diminishing the investor's risk of loss. Positions are considered to be offsetting if the value of each position moves inversely of the other and the positions are in the same personal property or debt instruments of a similar maturity. Before enacting the straddle rules, taxpayers would enter into offsetting positions with respect to the same security. One position would generate an unrealized loss, and another an unrealized gain (moving in opposite directions). At year end, the built-in loss position would be disposed of, recognizing a taxable loss in the current taxable year while deferring the gain on the built-in gain position. (Note that the straddle rules do apply to cryptocurrencies.)

The realized loss on the leg of the straddle is allowed as a current deduction only to the extent that such loss exceeds the unrealized gain, if any, on any offsetting position that remains open at the end of the year. One leg has been realized, and the other is unrealized at year end, generally with an unrealized gain. If the unrealized position was held more than 365 days (or long-term), then the loss that has been realized would be considered long-term due to the unrealized position's holding period. Until the straddle is broken, the holding period of the position generally does not continue to "count" until the offsetting position is disposed of. Any additional costs incurred related to the position when the straddle is in place are to be capitalized and added to the basis of the position.

To illustrate how a staddle can affect taxable income, below is an example and the resulting tax consequences.

- An investor buys 100 shares of ABC Stock for $8,000 on January 15, 2023,
- The investor then buys a put option on ABC Stock on January 30, 2023.
- The put option expires worthless on March 15, 2023, resulting in a $500 loss.
- On December 31, 2023, the investor still holds the ABC Stock, now with an unrealized gain of $1,500.
- Later, on February 15, 2024, the investor sells the stock for a gain of $2,100.

The loss of $500 from the put option expiration is deferred due to the unrealized gain of $1,500 at year end. When the stock is sold, due to the day count stopping and starting after the straddle is broken, the gain that is recognized, adjusted for the $500 loss, is a short-term gain of $1,600. If the unrealized gain on the stock was only $200 at year end, then $200 would be deferred and the other $300 loss would be recognized.

One way to mitigate the straddle adjustment is to make an identified straddle election. To make this election, the taxpayer has to determine the straddle on the books and records before the earlier of: (i) the close of the day on which the straddle is acquired or (ii) such time as the Secretary may prescribe by regulations. Next, to the extent provided by regulations, the value of each position of the straddle (in the hands of the taxpayer immediately before the creation of the straddle) must not be less than the basis of that position in the hands of the taxpayer at the time the straddle is created. Lastly, the identified straddle cannot be part of a larger straddle (e.g., a butterfly straddle). The loss deferral rules do not apply to an identified straddle, and the positions that are part of the identified straddle do not offset any positions not included in the identified straddle. Mixed straddles are another election that can be made where one or more of the legs of the straddle is a §1256 contract.

Lastly, an exception to the straddle rules is the qualified covered call option (short option on a stock where the taxpayer also holds a long position in the same stock). An option will not trigger a straddle adjustment when the taxpayer is not an options dealer, the option is traded on a Qualified Board or Exchange (QBE), the option was written more than 30 days prior to expiration, and the option is not "deep in the money." If these criteria are met, the option will not trigger a straddle adjustment if realized at a loss. A trader sometimes uses this strategy to generate additional income when holding a stock. If followed, and the written call option meets these criteria when opened, then the trader would not run afoul of the straddle rules.

Constructive Sales

A constructive sale is a third adjustment that can be encountered when investing and trading in the markets. As defined in §1259, a constructive sale is when the taxpayer has eliminated the risk of loss and the opportunity for gain on an appreciated financial position, effectively selling the position without realizing the gain. A constructive sale transaction is deemed to occur when the taxpayer enters into offsetting positions with respect to a security that is the same or substantially identical (in the same manner as wash sales and short sales provisions of the Code) to the appreciated financial position. Like the wash sale rules, the constructive sale rules do not apply to cryptocurrencies under current law.

A taxpayer deemed to have entered into a constructive sale will be treated as having sold the appreciated financial position at its fair value on the date of the constructive sale. Taxpayers must make proper adjustments, when the appreciated position is sold, to not double count the gain already recognized at the time of the constructive sale. This is done by adjusting the basis of the appreciated position to the fair market value on the date of the constructive sale. The holding period of the appreciated position will begin when the offsetting position is disposed of. In the case of multiple lots, the lots deemed sold are determined in the same manner as actual sales.

A common exception to the constructive sale rule is the safe harbor rule, also known as the short-term hedging exception, with three conditions. First, the offsetting position is closed within 30 days after the close of the taxable year in which the offsetting position was entered into; then, the appreciated financial position is held for at least 60 days, beginning when the offsetting position is closed. During this period, the taxpayer cannot enter into certain transactions that would diminish the risk of loss, leaving the appreciated financial position essentially unhedged. In addition to the short-term hedging exception, other ways to mitigate include using collars or the specific identification rules of §1259(e)(3).

Section 475(f) Mark-to-Market Election

If a taxpayer wants to avoid the administrative burden of making the adjustments discussed in this article, a §475(f) election can be made. Once the election is made, (1) all securities are marked-to-market annually and treated as ordinary income, and (2) securities analysis for wash sales, straddles, and constructive sales is not required. If an election is in place, specific positions within a portfolio could be excluded from the election if specifically identified and noted on the taxpayer's books.

The IRS does not set specific guidelines about the eligibility requirements to make a §475(f) election. Therefore, eligibility is a facts-and-circumstances analysis. In general, a taxpayer wishing to make this election would need to be in the trade or business of trading in securities on a regular and recurring basis. Some general parameters that should be reviewed to determine if the trading activity is sufficient to make the election are a review of the fund's investment strategy, portfolio turnover, amount of qualified dividends, and volume of trades (to mention a few). Accumulating these data points would assist in deciding the election.

For a new entity (e.g., an investment partnership), the election must be made within two months and 15 days after the first day of its initial tax year. For an existing entity to make the election, the election must be included with the extension that is filed in the year it is intended to take effect (e.g., for the election to be in place for 2024, the election must have been included with the 2023 extension that was due March 15, 2024). The election for an existing entity is considered a change in accounting method, and automatic consent can be obtained by filing Form 3115 with a timely filed tax return. If a valid election is in place and a later-year decision is made to revoke the election, this can be done under Revenue Procedure 2023-24, Section 24.02. The taxpayer cannot elect back into §475(f) for five years.

With the §475(f) election comes advantages and disadvantages. One of the primary drivers for the election is no longer having to track securities adjustments on the trading activity. The election benefits a trader who actively trades securities, entering and exiting positions frequently. Losses that are unrealized at the end of the year are recognized as ordinary losses and are not subject to capital loss limitations. One last advantage is the reduction in book-to-tax differences. For an investment partnership it is much easier to compute and provide investors the taxable income for a year when a §475 election is in place due to the securities adjustments not being required. This creates efficiencies in tax reporting.

One significant disadvantage of the §475 election is that unrealized gains at the end of the year are recognized as ordinary income. Further, if positions have been held for more than one year, and a specific carve-out has not been done on the books, these gains are pulled into the mark-to-market income as ordinary income, as opposed to being treated as long-term capital gains subject to the beneficial tax rates. If significant capital loss carryover exists for a taxpayer from years before the election being made, assuming no other sources of capital gains, they can only offset §475(f) income with $3,000 of capital losses.

Conclusion

Navigating the complex landscape of tax adjustments for securities trading requires a thorough understanding of key tax concepts and rules. By carefully considering these concepts and rules, investors and traders can make informed decisions that align with their trading strategies while fulfilling their tax obligations efficiently and effectively.

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