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THE TAX-CONSCIOUS ADVISER

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When buying puts to protect profits

Be aware of all the possible tax surprises lurking in the shadows when employing this strategy

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Some clients are asking about buying puts to protect the profits that they have earned. Of course, there are possible tax surprises when using puts to hedge, and none of them are pleasant.

When one buys puts on a stock as an outright speculation, calculating the taxation is easy. The put is an asset one owns, and even though it is a “bearish bet,” the put purchase is taxed like any other asset: Hold for less than 12 months and it is a short-term gain; hold for more than 12 months, it is a long-term gain.

When one buys puts to speculate on an index, the taxation could change. Exchange-traded index options are afforded special tax treatment: all gains and losses are treated as if 60% are long-term and 40% are short-term.

This tax treatment also applies to exchange-traded options on other underlying investments that are non-equities, such as an option on SPDR Gold Trust (GLD).

When buying a put to protect a single equity position one must be aware of a few “hidden” traps to the hedge. If an investor owns a stock with a long-term unrealized gain, he or she can buy a put that won't affect the holding period.

If, however, one buys a put on a share with unrealized short-term gains, there is a penalty built into the tax law. The put completely destroys the holding period of the shares.

As an example, let's say an investor held a stock for 11 months and then because of a temporary concern he or she bought and held a put on the stock for a few days.

If the investor, no longer worried, sold the put, he or she would need 12 months more of holding to get to long term, not just one more month as would have been the case if the holding period was just frozen rather than destroyed.

Those who own a portfolio of stocks and buy an index put to hedge those shares won't affect the holding period as long as the portfolio doesn't overlap the holdings of the index by 70% or more. If the portfolio

owns an S&P 500 exchange-traded fund and the investor buys S&P 500 puts, it will stop the short term/long term clock and compromise the taxation of the dividend on that percent of the portfolio.

The second issue that isn't obvious to investors but can be quite costly occurs when a put is bought on a dividend-paying stock.

Investors are usually aware that a stock must be held for a minimum of 61 unhedged days in order for the dividend to be qualified for the preferential dividend tax rate of 20%. What most people aren't aware of is that on every record date the investor must have a “good” 61-day holding period.

As mentioned, the purchase of a put freezes or destroys a holding period so that the purchase of any put on the stock will cause the dividend to be taxed at almost twice the the preferential rate — 39.6%.

It is worse if an investor is buying a put on a foreign company stock that is paying a dividend. If an investor held Royal Dutch Shell unhedged, he or she would keep 80 cents after tax of every $1 dividend paid.

On foreign shares, the foreign government withholds on the dividend, and the taxpayer gets even by using the “foreign tax credit” on the amount withheld. The utilization of the “foreign tax credit” is also limited to when the holder has a “good” holding period over the record date.

So the purchase of the put will “disqualify” the dividend and render the investor unable to take advantage of the tax credit. Instead of keeping 80 cents of every foreign-paid dividend, the investor is keeping just 51 cents of every dollar.

Taxpayers with other investments where they can use the credits would net only 45 cents of every dollar of foreign dividend.

The last tax issue concerns straddles. We are advised that shares bought after 1984 can become part of a straddle.

Once an investor buys a put on the shares, he or she has created a straddle for tax purposes. Then the investor isn't allowed to deduct any trading losses derived from trading one of the pieces of the straddle.

But the investor must still pay tax on any trading gains.

As an example, an investor buys a put for $5, and the stock stays where it is and the put expires worthless. The investor has to defer the taking of the $5 loss until he or she disposes of all legs of the straddle.

If instead, the stock falls and the investor sells the put for $11, he or she must pay tax on that $6 of realized short-term gain.

Investors must walk in with their eyes open to the “hidden” possible tax costs of buying protective puts.

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