Single Stock Futures and Taxes

This new tool can be a great hedging device — but watch out.

By Robert N. Gordon

Single stock futures (SSFs) are off to a running start. Volume is respectable and pricing is being kept very close to theoretical values — all of which bodes well for SSF inclusion in a registered rep's toolbox. Unfortunately, without the right information on the tax aspects of SSFs, brokers can inadvertently hurt investors.

Here are some points to consider.

The Commodity Futures Modernization Act makes clear that using an SSF to hedge will stop your holding period. When the hedge comes off, the holding period will start again at day one. As a result, when you hedge with an SSF, you will not be aging the position to long term. In fact, you'll undo any holding period you accrued before you put on the hedge. This holding period rule also applies to the 46-day holding period required for any dividend to receive the 70 percent dividends-received deduction.

Further, if a hedge using SSFs is held over a year-end past January 31, it will trigger gain as if the stock were sold (this falls under the Constructive Sale Rules). This "constructive sale" only applies to gains; you cannot use this method to harvest losses. You can, however, use SSFs to construct temporary hedges within a calendar year.

A deferral of gain from one year to the next can be accomplished on up to half your position by using the law's specific identification rules. You do this by hedging with SSFs and identifying which shares are being hedged, then holding the position until January of the next year, when you deliver the unidentified shares against the SSFs. This strategy is not unique to SSFs; it can also be accomplished with short sales.

The Commodity Futures Modernization Act also makes clear that replacing a losing position with an SSF will trigger the wash sale rules. This aspect of the Act may be disappointing because some practitioners had believed that a cash-settled derivative was not caught by the wash sale rules. This Act extends the rule to all cash-settled derivatives and puts the debate to rest.

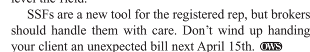
On a more positive note, SSF investors can find advantages on the long side because the margin for these securities is only 20 percent, for leverage of five-to-one. This contrasts with the Fed's 50 percent margin requirement, affording two-to-one leverage on equities.

There is also a tax advantage to owning SSFs versus call options if you plan on taking delivery of the underlying shares. When you exercise an option you start your holding period, but when you take delivery under an SSF you tack on the holding period from the day you first entered the SSF.

SSFs can be most useful to investors on the short side.

On a non-tax note, SSFs can be most useful to investors on the short side. Many of the headaches of shorting are nullified by using SSFs. You do not need an uptick to sell SSFs as you do with shares themselves. Also, you do not have to "locate and borrow"shares for delivery from your stock loan department. More importantly, you cannot get caught in a short squeeze using SSFs, as you can shorting physical shares.

The pricing of SSFs should include an interest factor added to the market price of the shares. A one-year SSF on a $100 stock paying no dividend should be priced at $100 plus the current one-year T-bill rate. While shorting physical securities, this interest factor is normally captured as a "short interest rebate" that, unfortunately, eludes many investors because they either do not know about it or are not a big enough customer to demand it. The automatic inclusion of the interest rebate in the pricing of SSFs should help to protect smaller players and level the field.



SSFs are a new tool for the registered rep, but brokers should handle them with care. Don't wind up handing your client an unexpected bill next April 15th. OWS

Bob Gordon is President of Twenty-First Securities Corp. (www.twenty-first.com), an adjunct professor at New York University's Graduate School of Business and a member of the Wall Street Tax Association. He is also the author of "Wall Street Secrets for Tax-Efficient Investing" (Bloomberg Press).