Cambyses Financial Advisors, LLC
Steven Roy Management

Income Taxation of Simple Options and Wash Sales

Cambyses Financial Advisors, LLC
Steven Roy Management

13027 Victory Blvd. PMB 722
North Hollywood, CA 91606
WWW.StevenRoyManagement.Com

[o] (818) 489-4228
[f] (818) 450-0426
Steven@StevenRoyManagement.Com

Drafted By

- Steven J Roy MS, MST, EA (Chief Operations Officer)

Reviewed By:

- Nastaran Motiei MBA (Chief Executive Officer)

Revised: 08/2020

Table of Contents

Principal Author: Steven J Roy MS, MST, EA, MRP 3
Disclaimers and Disclosures 4
Preliminary Determinations 5
  What (and how) do you trade? 5
  What happens at closing? 7
  The nature of option income and its taxation: 8
  Your 1099B may be incorrect – and no one may notice. 10
Simple Option Scenarios 11
Wash Sales: Identification and Timing 14
  Basic wash sale concepts and mechanics 14
  Substantially identical securities 15
Trader vs. Investor 17

Steven@StevenRoyManageemnt.Com

Principal Author: Steven J Roy MS, MST, EA, MRP

Fellow of the National Tax Practice Institute

Steven is currently Chief Operations Officer of Steven Roy Management, and Chief Operations and Compliance Officer for Cambyses Financial Advisors, LLC. For nearly forty-five years Steven has provided business development, management consulting, financial management, and tax services to aviation, entertainment, hospitality, technology, service companies, and real estate ventures. Through Steven Roy Management, Cambyses, and their predecessors, Steven has provided financial expertise to over 1,100 business ventures.

Steven has served as a director, officer, or trustee for over thirty-five public and privately held companies. He taught finance, taxation, and management to fellow professionals through UCLA Extension Services, has been a contributing editor for several professional journals, and has authored four book length publications (finance, tax, and economics). Steven was recognized as a Fellow of the National Tax Practice Institute in July 2003.

A community activist, Steven supports not-for-profit organizations, civic and municipal activities, and churches-church administrators. He currently serves on the Board and as CFO for Advanced Heliophysics (A joint research project of JPL, UCLA, Cal-Tech, NASA, and NOAA) and Future XO. He is a Board Member of the Los Angeles Mounted Police Foundation and a management advisor to The New Festival, New York's LGBTQ Film Festival. Steven has served on the board of directors for the Tennessee Shakespeare Festival, World Heart Association and over 50 other arts, social, and humanitarian organizations. He was a member of the IRS National Technology Task Force and a financial affairs consultant to the United States Green Building Council and the Los Angeles Public Safety Employee Division. Internationally (through Crisis Recovery International) Steven has assisted development projects in Nepal (Women for Human Rights), Sri Lanka (Association of War Affected Women), India, Viet Nam, and the Philippines.

A graduate of UCLA (BS) and USC (MS), Steven also holds an MS in Taxation from California State University, Fullerton (Beta Gamma Sigma), and professional designations in real estate investment, financial planning, entertainment finance, accounting, and equine operations. Steven is a licensed California Real Estate Broker (CalBRE License # 01706626) and broker of record for Steven J Roy Management. He is Managing Member and an Investment Advisor Representative (CRD #6499051) for Cambyses Financial Advisors LLC (CRD #230786). He is also an Enrolled Agent (Federal Registration #036074) and is enrolled to practice before the Internal Revenue Service's Compliance, Examination, Appeal, and Collections Divisions.

Disclaimers and Disclosures

The information contained in this publication has been gathered from sources that are believed to be reliable but is not guaranteed as to completeness, currency, or accuracy.

Nothing contained in this publication should be construed as the giving of business, legal or tax advice or the making of a recommendation. It should not be relied on as the basis for any decision or action. The information contained in this document is general in nature and may not apply to the specifics of your situation or transaction. You must rely only on the advice of qualified tax and/or legal counsel to advise you on your specific situation or transaction.

Steven Roy Management, the authors, or their affiliates do not represent or warrant that this information, including any third-party information, is accurate, current, or complete and the information should not be relied on as such.

The data and analysis contained in this publication are provided "as is" and without warranty of any kind, either expressed or implied as to its accuracy, completeness, timeliness, originality, merchantability, fitness for a particular purpose and/or non-infringement. Neither Steven Roy Management, the authors, nor their affiliates, employees, nor any third-party provider, shall have any liability for any loss sustained by anyone who has relied on the information contained in any publication produced by them.

In no event, shall Steven Roy Management, the authors, nor their affiliates have any liability for any direct, indirect, special, incidental, punitive, consequential (including without limitation, lost profits) or other damages. Nothing contained in this document is intended to create a contract (express or implied), or any other legal right or remedy or otherwise to create legally enforceable obligations on the part of Steven Roy Management, the authors, or their affiliates.

All opinions expressed are subject to change without notice.

IRS Circular 230 Disclosure

In order to comply with requirements imposed by the Internal Revenue Service, we inform you that any U.S. tax advice contained in this communication (including any attachments) is not intended to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.

Preliminary Determinations

What (and how) do you trade?

Different tax regimes for different trading approaches: Tax rules distinguish securities investors from securities traders and securities dealers (brokers-custodians). Options are considered securities. Most of our discussion here focuses on:

- Investors: Who enter option transactions for their own account (usually with the assistance of a broker-dealer-custodian); and
- Traders: Who also enter securities option transactions for their own account but do it far more frequently and with a single-mindedness that amazes, or appalls, their friends and colleagues (if they have any).[i]

The transactional-computational aspects of option taxation are the same (or similar) for both investors and traders. Traders, however:

- Report gains, losses, and net income on different tax forms than do investors (Schedule C rather than Schedule D),
- Deduct a wider range of expenses, on more favorable terms, than investors,
- Pay Self-Employment Tax on their net taxable income from trading,
- Qualify for benefit and pension funds for themselves and fund them based on their taxable income from trading, and
- Use different accounting conventions from investors {mark-to-market, IRC §475(f)}[1]

For the sake of closure, we note that our discussion here does not apply to:

- Securities Dealers: Who purchase, hold, and sell securities to their customers in the ordinary course of their trade or business and derive their income from marketing those securities to customers.
- Securities Investment Advisors: Who, in the ordinary course of their trade or business, assist and advise customers who purchase, hold, and sell securities, and derive their income from marketing those services to customers.
- Commodities Dealers and Advisors: Who are subject to an entirely different regulatory and tax framework.

In what follows, we underline the words investor and trader if the material applies only to one or the other. We will use the generic pronoun, you, if the material applies to both investors and traders.

[1] Investors are not permitted to use mark-to-market. Traders are required to use it.

Steven@StevenRoyManageemnt.Com

It is possible that your trade activities fall into more than one cubbyhole: e.g. Dealers and Advisors are almost always Investors as well. Many Dealers are both Investors and Traders. Be prepared to either spend a great deal of time and effort accounting for each separate activity or be prepared to pay someone else to do it.

Securities options are taxed like securities: Gains or losses on most investor option positions are recognized (included in taxable income) when the transaction closes (trade date). Investors' tax basis and gain or loss on a position is computed the same way that basis, gain or loss is computed for accounting and other tax purposes (IRC §1001 et. seq.).[2] The most common exceptions include:

1. If you close-at-a-loss and buy substantially identical positions within a thirty (30) day window, the loss is not recognized for tax purposes until you close the last position in the chain (called a wash sale, IRC §1091, the deferred loss is applied to adjust the basis of the open position);
2. If you maintain offsetting positions[3] and close only the losing position, some of the loss may not be recognized for tax purposes until you close the winning position (called a straddle, IRC §1092, the loss is recognized only to the extent it exceeds the gain in the winning position, the balance of the loss is applied to adjust the basis of the open position);
3. If you acquire stock at closing, the premium you pay or receive and the transaction costs you incur are incorporated in the acquired stock's tax basis (the Basis Rule). Tax gain or loss on the option transaction is not recognized until you dispose of the acquired stock.

The Wash Sale, Straddle, and Basis rules[4] introduce timing differences between what you report for tax purposes (recognized gain or loss) and what you record in your accounting records (realized gain and loss). Those timing differences eventually resolve themselves – total tax gain or loss reported eventually equals total accounting gain or loss (e.g. when you close all the legs of the affected-related transactions). However, differences may persist for a long time and may cross over from one accounting-tax period to the next.[5] Bear this in mind when you reconcile your brokers 1099B to your accounting records.

---

[2] Basis = What you paid to bring the asset to its current condition and place; Gain or Loss = Sales Price – (Basis + Cost of Sale). This rather broad over-generalization works well for most securities trades, including most option trades.

[3] Call and a put in the same security, with the same expiration date.

[4] The terms wash and straddle are part of the vocabulary of both option traders and tax professionals. The terms do not mean the same thing in both contexts!

[5] That possibility is the heart of Wash Sale and Straddle rules. In the absence of a Straddle Rule, closing a loss position near the end of year one, and an essentially identical gain position at the beginning of year two (or vice versa) shifts tax burden from one year to the next. The amount shifted: roughly twice the tax bill or benefit from the completed option chain.

Gains or losses on traders' option positions are recognized (included in taxable income) periodically throughout the trading period; at inception, on one or more measurement dates during the holding period, and when the transaction closes (trade date). The gain or loss formula that applies at each measurement date is conceptually the same as that used by investors:

Gain or Loss = "Sales Price" – ("Basis" + Transaction Costs)

However, for traders both "Sales Price" and "Basis" become moving targets. "Sales Price" on the current measurement date is the amount you could receive if you closed the option today (the current bid price for an option on a reasonably active security). "Basis" on the current measurement date is the "Sales Price" from the preceding measurement date. Mark-to-market accounting breaks the eventual gain or loss in the position into a series of gains or losses that 1) allocate the tax consequences of the transaction to the periods in which they occur, and 2) equal, in total, the gain or loss for the entire holding period.

Because mark-to-market limits the opportunity to manipulate tax-timing, traders are exempt from the Wash Sale rule. The Straddle and Basis rules both apply equally to investors and traders. Hence, both investors and traders may observe timing differences between what you report for tax purposes (recognized gain or loss) and what you record in your accounting records (realized gain and loss).

In theory, the IRS could challenge your choice of either investor or trader status. In practice, Steven Roy Management has never had to represent a client who chose to consider themselves an investor. Service challenges to clients who considered themselves traders have, by contrast, been frequent – particularly in years where bears dominate the market. From this, we conclude that the IRS considers trader status to be more advantageous than investor status. We think the jury is still out on that one.

What happens at closing?

Any option position can be closed in at least four different ways:

1. Sell, Buy, or Trade,
2. Rollout,
3. Expiration (lapse), or
4. Assignment or Exercise

What happens at closing determines both the incidence and timing of gain-loss recognition. By extension, what happens at closing determines how much tax you pay on the transaction and when you pay it. Tax treatment of each scenario is slightly different. Tax treatment in any given scenario may depend on whether you close at a gain or at a loss.

The disparate tax outcomes dictate that you learn the tax principles, rather than memorize formulas. The wisdom of that suggestion becomes clear when you realize that even a simple naked option strategy produces twelve to sixteen different tax outcomes. For any naked option you can:

Action	***Number of Possibilities***
Buy or Sell to Open	2
A Put or Call, and	2
Can Close by Expiration, Close, Execution (or Assignment), and Rollout	3-4
A total of	12-16 Outcomes[6]

The potential tax outcomes are multiplicative: the more options in the strategy, the more potential outcomes. Fortunately, there are a few generalizations that simplify the logic:

- Transaction costs always reduce recognized gains (or increase recognized losses),
- If you acquire or receive shares at close (usually by execution or assignment), gain or loss on the option transaction is not recognized, The options' holding period is tacked to the share's holding period when you subsequently sell the shares. The cost of the option and transaction costs are absorbed in the basis of the shares,
- If you surrender or sell shares at close (e.g. you Sell to Open a covered call and are later assigned) gain-loss on the option position and the surrendered shares is recognized as if the option and surrender was a single transaction. Holding period is determined based on the holding period of the surrendered shares. The option's holding period is disregarded.

The nature of option income and its taxation:

The Internal Revenue Code recognizes overlapping income classifications. The most common and relevant to our topic are:

- Ordinary income: "Earned income" from wages, salaries, commissions, net business income, and sales of assets that are not held for investment (or for use in a trade or profession). Ordinary income is taxed at "ordinary income tax rates:" the least generous (highest tax) tax treatment,

[6] Note that there are, in practice, twice to four times this number of possible combinations; the gain-loss may be short or long term and may be realized by either an investor or a trader. Who says the tax code is too complex?

Steven@StevenRoyManageemnt.Com

- Capital Gains: The gain on disposition of assets held for investment purposes. Capital gain income is short term or long term depending on how long you own the asset. Short term capital gains are taxed at the same rate as ordinary income. Long term capital gains are taxed at about half the ordinary income tax rate. Some states [California among them] do not recognize any difference between ordinary and capital gain income [long or short term]. These states tax capital gains at ordinary rates, but usually require them to be reported separately.
- Portfolio Income: Interest, dividends, royalties and similar payments. For some purposes, such as the Net Investment Income Tax (NIIT) capital gains are included in this classification. Portfolio income is taxed at favorable tax rates – e.g. at capital gain rates on your Federal return. However, if your total income exceeds a threshold, some or all of you your portfolio income [including capital gains] will be subject to the Net Investment Income Tax (NIIT), a 3.8% tax rate increase or surcharge.

Capital gain income is classified as long term capital gain or short term capital gain depending on how long you own the asset. Gains on assets that you hold for longer than one year (one year and one day) receive the favorable (lower) long term gain rate. Assets that you hold for one year or less face tax at the (usually higher) ordinary income tax rate. Since the difference between the two rates can be 15-25%, it is important to know and follow the rules.

- The holding period begins on the day after an option is created, purchased, or traded. For this purpose, the option is deemed to have been created, purchased, or traded on the trade date, not the settlement date. E.g. Trade date = 12/01/yr01; Settlement date = 12/04/yr01; Holding period begins 12/02/yr01.
- The holding period ends on the day you close the option position (again; trade date, not settlement date).

If, in our example the holding period ends on 12/02/yr02 or after, the gain or loss is long term. If you close the position before 12/02/yr02, the gain or loss is short term.

By now you have probably realized that most gains and losses on option trades will be short-term; subject to ordinary income taxation. So, why do we even bother with this discussion?

- In some instances, e.g. wash sales, the holding period for the first position in the chain is “tacked on” to those of subsequent positions. Thus, the holding period for the chain may be long term even though each transaction in the chain is short term.
- In transactions that require you to convey shares at close (usually due to execution or assignment), the holding period is determined by reference to your holding period for the shares, not the option. This sometimes creates long-term gain opportunity.
- More importantly, capital gains (of either stripe) are first netted against capital losses of the same duration, net gains are immediately taxable. Net loss deductions are, however, restricted. Careful disposition planning can mitigate this impact.

Your 1099B may be incorrect – and no one may notice.

Broker-custodians report closed option positions on your Form 1099B.[7] Both you and your tax professional need to check the broker-custodian's work.

The most common 1099B errors we encounter at Steven Roy Management include:

- Adding when they should subtract (rare now, but we saw it a lot on 2014 1099Bs),
- Incorrect opening transaction amount or share basis, (prevalent on inherited positions, ubiquitous for shares acquired by assignment or execution),
- Incorrectly identified wash and straddle sales, {Most brokers software identifies a transaction as a wash sale only if it involves "identical securities" (Purchase and sale of exactly the same security). The code identifies transactions in "substantially identical securities"[8] as wash sales and requires that you treat them as such. See below},
- Failure to integrate wash sale losses with subsequent transactions,
- Failure to recognize straddle or similar deferred recognition transactions, and
- Different interpretation of the rules (Some broker 1099B software does not reconcile well with personal trading systems like Trade-Log.)

The "errors and omissions" issue does not end with your broker, either. Very few tax professionals understand option trading and option taxation. Often, tax professionals who do understand the rules are too busy and exhausted to notice the broker's reporting errors. You may need to become the "local expert" on this one… bird-dogging your broker and your tax professional every step of the way.

The 1099B's accuracy, or proper corrective reporting of the broker's errors on your tax return, can be critical. As a "third party report," The IRS has the right to (and will) rely on the broker's 1099B when it comes time to match your return to the known "facts" about your income.[9] The first hint that there is trouble afoot usually arrives about two years after you file your return. Once the IRS computers have

---

[7] For years ending after 12/31/2013.

8 Convertible bonds, convertible preferred shares, and call or put options that can be converted into common shares of the same issuer are considered substantially identical to each other and to the issuer's common shares.

[9] Technically, the Service's "right of reliance" shifts the burden to prove errors and inaccuracies in a third-party document from them to you. In practice, their approach at examination and appeals levels is both more flexible and more practical than that suggests.

run all their "income matching" algorithms the Automated Collection System creates a "Notice of Proposed Adjustment," and you are off to the races. We discuss proper corrective reporting in a sidebar, below.[ii]

The good news is that the IRS is not pursuing straddle and wash sale issues very aggressively with small traders and investors and have backed off from their once-rabid stance with large traders and investors.[10] About 85% of proposed assessments are resolved through correspondence (if you do it in a timely manner). This is little consolation if you are the one being examined in the Service's office, or if the Service once again goes on an anti-straddle or wash sale rampage, (Which some practitioners expected to happen once the 1099B reporting system is de-glitched. It never happened.).

Practical suggestion: If you trade frequently, you may not want to pay your tax professional to re-enter and de-bug several thousand transactions. Many mid to high end tax software packages can (with your permission) access your brokerage records to simplify data entry. Choose a broker-custodian and tax professional whose software integrates. That way, your tax professional can download and review your transaction history without having to re-input it.

The Service now permits preparers to summarize "Covered Transactions" without reproducing the detail that goes into them. Covered Transactions include long or short-term gains and losses for which the broker discloses to the Service; Basis, Amount Realized, Open Date and Closing Date for each transaction, and summarizes the cumulative result. Brokers have been required to report in that fashion since 2014. Thus, only the increasingly rare "Non-Covered Transactions" need to be detailed on your return. For active investors and traders, that saves a whole bunch of tax compliance fees.

Simple Option Scenarios

The simplest option scenarios involve sale or purchase of an option followed by a "clean close;" expiration, sale to close, or execution/assignment. In simple option scenarios, we assume the option is naked (not covered) and that the position is completely extinguished for at least thirty days once it is closed (i.e. that you do not roll out, up or down, and that you do not acquire any "substantially similar position" inside the thirty day window.)

Notwithstanding those simplifying assumptions, the investor's tax outcome table is a bit daunting.

---

[10] The Service once announced it would "pursue every straddle dispute through the entire examination, appeal, and litigation process." They backed-off when exam backlog reached about nine years – six months after they announced the policy. By-The-Way: this observation is a de-facto sigh of relief, not strategic or tactical tax advice. Playing the audit lotto is never very bright. Tax professionals are specifically prohibited from considering "audit probability" when they take a position on a return or when rendering a tax opinion on a "first impression" basis.

Cambyses Financial Management, LLC.
Tax Outcome Table – Simple Option Strategies/Positions

(Revised: 20160222)

Open		**Close**	**Taxable Gain, Loss, or Other Outcome**	**Symbols Used**
Purchase To Open	Put	Expire	Loss = PO + TC	PO = Purchase Price of the Option You Bought to Open PC = Purchase Price of the Option You Bought to Close (Cash Paid at Close) SO = Sales Price of the Option You Sold to Open SC = Sales Price of the Option You Sold to Close (Cash Received at Close) TC = Transaction Cost (Open + Close) Strike = Strike Price of Option When Executed OB = Basis, stock position used to fulfill option SB = Basis, stock position acquired on execution
		Close	Gain or Loss = SC – {PO + TC}	
		Execute	Gain or Loss = Strike – {OB + PO + TC}	
	Call	Expire	Loss = PO + TC	
		Close	Gain or Loss = SC – {PO + TC}	
		Execute	Gain or Loss = Not Recognized SB = Strike + PO + TC	
Sell To Open	Call	Expire	Gain = SO – TC	
		Close	Gain or Loss = SO – {PC + TC}	
		Execute	Gain or Loss = {SO – TC} + {Strike – OB}	
	Put	Expire	Gain = SO – TC	
		Close	Gain or Loss = SO – {PC + TC}	
		Execute	Gain or Loss = Not Recognized SB = Strike + TC – SO	

Closing triggers taxation (or tax consequences) for all the simple scenarios. Premium you receive to assume a short position and/or premium you pay for a long position are not taxed when received or deducted when paid. Instead, the trade's consequences become taxable (recognized) only when you close the position.

For investors, your trade intent (risk management, speculation, income) has no relevance to its taxation. The nature and timing of tax recognition depends entirely on the transaction dynamics: purchase, sale, and transaction costs; timing of the open and close.

Except for scenarios in which shares are acquired (long options), income tax revenue recognition conventions align reasonably well with both investors' sense of gain and loss and with Generally Accepted Accounting Principles (GAAP). Some investors, however, conceptualize option transactions in which shares must be delivered (e.g. sell call to open, execute or assign to close) as two distinct transactions (Sell the call option for income, Sell the shares for gain or loss) – a distinction that neither GAAP nor tax conventions support.

Unless you trade LEAPs, most naked option positions expire in one or several months. Therefore, most investors' recognized gains and losses on naked options are short term capital gains. If, you deliver or liquidate shares to close the transaction (e.g. if you Sell Call to Open, are executed or assigned, and cover your short position by conveying shares) the gain or loss is short-term capital gain regardless of the holding period of the shares you deliver to cover your short position.[11] All traders' gains and losses are ordinary income.

When investors receive shares in the transaction (e.g. sell put to open, execute or assign to close) the closing trade date becomes the first day of the holding period for the shares (The option holding period is irrelevant). Gain on the subsequent sale of the position may, accordingly, be either long or short-term capital gain, depending on how long you hold the shares. Gain or loss for the subsequent sale is determined as:

Gain or Loss = Sale price of the shares on disposition – (Basis of shares as determined in the option close + Transaction costs of disposition)

The nature of the gain or loss (long or short term capital gain) is determined by reference to only the holding period of the stock. Disregard, the option's holding period.

A reminder: While technically "doable," some naked option strategies (e.g. sell naked call to open) expose you to potentially catastrophic losses. In the sell (naked) call to open scenario, for example, losses are potentially unlimited. Therefore, many broker dealers will not allow inexperienced option investors or traders to initiate these positions unless the position is covered or other loss limitation measures are in place.

Under the wash sale rule, the loss on disposition of a securities position is not recognized for tax purposes if, within thirty days before or after disposing of the loss position, you purchase substantially identical securities.

[11] If you close the short position by paying cash, the gain or loss is short term. In short transactions, you never actually "own" what you sold. Hence the short-term gain.

Steven@StevenRoyManageemnt.Com

Wash Sales: Identification and Timing

Basic wash sale concepts and mechanics

Like many tax concepts, if you understand why the wash sale rule exists, you understand how it works.

Briefly: The wash sale rule[12] is intended to prevent investors from recognizing losses on stocks they still own.

Somewhat less briefly: The Treasury, Congress, and the tax authority do not want to "pay-the-bill" (in the form of a reduction in your tax exposure) when you voluntarily engage in a series of transactions that produces a tax-loss but no appreciable change in your economic position.[13]

The wash sale rule is not new.[14] It is one of the oldest anti-abuse provisions in the Internal Revenue Code, added to the code by the Revenue Act of 1921. Effective enforcement of the rule on a broad and consistent basis, however, awaited the Big Data era. Small investors did not feel the rule's impact until 1099B reporting rules changed in 2014. Before 2014, it was simply too much effort for the Service to pursue the issue except when they examined large investors and traders.

Illustration One: You own 100 shares of XYZ. Current market price for XYZ is less than your basis in the shares. You sell your position (realizing a loss) and purchase 100 shares of XYZ three days later. Some (or all) of the loss is not recognized for tax purposes. Instead, the deferred loss increases your basis in the new XYZ shares. The loss is recognized only when you dispose of the newly purchased position.

Illustration Two: Reversing the order of the sale and purchase transactions does not affect the outcome.

Illustration Three: Carrying out the trades in different accounts (e.g. in two accounts you hold at different broker-custodians, or in separate accounts owned by you and your spouse) does not affect the outcome: Even if the brokers do not report the transaction as a wash sale! Proper reporting is your responsibility, not the broker-custodian's.

---

[12] IRC §1091 and CFR §§1.1091-1 and 2 A wash sale (tax concept) is not the same as a wash trade (securities fraud concept) Section 15(a)(1) of the Securities and Exchange Act of 1934; Section 9(a)(1) and Section 10(b) of the Exchange Act of 1934; and SEC Rules 10b-5(a) and 10b-5(c). However, it is conceivable (indeed, likely) that a wash trade falls within the ambit of the wash sale rule.

[13] Properly done, your net-worth, on an FMV basis, after a wash sale is the same as it was before the transaction; less only the transaction cost.,

[14] Though you will occasionally hear tax professionals cite "novelty" as an excuse for return preparation errors involving this issue. The rule is "novel" only in the sense that few taxpayers trade frequently enough to encounter it; so, the tax professional does not see it very often.

The Service applies "related party" rules that extend the wash sale rule's reach to spousal accounts as well. Selling in your own account and buying in your spouse's account (or vice-versa) triggers the wash sale rule.[15] If done repeatedly and not properly reported, the pattern begins to look a lot like tax fraud – at least to always suspicious IRS agents-auditors.

Selling for a loss in your non-exempt account and purchasing replacement shares through your exempt account (IRA, SEP, Qualified Plan) is a wash sale. The loss will eventually be recognized in the non-exempt account. However, your basis in the exempt account will not be adjusted.[16] – The loss' tax benefit is wasted.

Illustration Four: If you separate the purchase and sale by at least thirty-one days, the wash sale rule does not apply. (But a lot can happen in thirty-one days!)

The wash sale rule is mechanical – any purchase and sale-at-a-loss that meets the wash sale criteria is a wash sale and results in loss deferral. Your intent is not relevant. The fact that each leg of the wash sale involves different and unrelated principals (usually because the trades occur on an option exchange) is similarly irrelevant.

Critical Note: The wash-sale window is sixty-one days long, not sixty. When determining the trade windows' beginning and ending dates, the disposition date is not counted. However, if both legs of the disposition-purchase close on the disposition date they constitute a wash-sale.

Fact of Life: Option investors and traders trade frequently. That fact alone implies option investors and traders will encounter wash sales often. The wash sale rule applies to transactions that involve "substantially similar securities," not just "identical securities." This distinction sometimes extends the wash sale rule into places you did not intend to go!

Substantially identical securities

Despite its ninety-five-year history, it is hard to pin down what the phrase "substantially identical securities" means. IRC §1091 employs the phrase but is not very specific. The IRC §1091 Regulations do not even mention the concept. Thus, the definition must be

[15] This IRS position has not been unanimously endorsed by the courts. IRS's position is particularly vulnerable if the spouses have separate accounts and act independently.

[16] Revenue Ruling 2008-5

Steven@StevenRoyManageemnt.Com

inferred from case law and administrative rulings. The Service has summarized those inferences (with a distinct bias in favor of their own position) in Publication 550[17] where they state:

- "Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation;" (e.g. Dell's common shares are not substantially identical to other computer manufacturers' shares.)
- "…bonds or preferred stock of a corporation are not ordinarily considered substantially identical to the common stock of the same corporation. However, where the bonds or preferred stock are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may make these bonds or preferred stock and the common stock substantially identical."

The caveats in those statements trip up option traders and their advisors. Options are eminently "convertible" to the underlying stock; even if that privilege is never exercised or assigned. Further, their value is entirely dependent on the underlying stock's price movement. We are forced by facts and circumstances to conclude that options are "substantially identical" to the underlying stock within the meaning of the IRC. Thus:

- The basis adjustment rules and arithmetic in the "Purchase Call to Open" or "Sell Put to Open" then "Execute or Assign to Close" (See *Simple Option Scenarios*, above), reflect (without directly acknowledging it) both; the "substantial similarity" of the options to the stock and the tight timeframe in which the option is extinguished and the stock is purchased (usually literally immediately). Implicitly, both these transaction scenarios are treated as wash sales, whether they represent a gain or a loss.
- Many wash sales are "accidental." The most common unintentional option-related wash sale plays out over four transactions: Purchase and sale of the underlying stock; Purchase and close of a call on the underlying stock; within the 61-day window. Develop a trading plan that acknowledges this possibility and monitor your transactions (equities and options) to head off this outcome.
- Convertible bonds and options to purchase or sell them may also trigger the wash-sale rule.

[17] IRS Publications are not precedential; they cannot be cited as authority for a position by either the taxpayer or the IRS (Though IRS agents sometimes overlook that fact when it suits their convenience.) Nevertheless, Publications are a reasonably good gauge of the IRS position on any given issue. Following the Publication guidelines usually eases the examination-appeal-litigation path.

Practical Observation: Option investors should be especially careful before they act on pundits' knee-jerk recommendation that they "Harvest Losses" at the end of the year. Quite apart from the recommendation not being universally advisable,[18] option traders who follow the advice risk inadvertently triggering the wash sale provisions.

Trader vs. Investor

---

[i] **Sidebar: Trader vs. Investor.** Despite its far-reaching consequences, the distinction between securities investors and securities traders is more a matter of degree than of kind.

Just to add to the uncertainty, it is entirely possible to be simultaneously be a trader with respect to some securities in your portfolio and an investor with respect to others.

The IRS considers you a trader if:

- You seek to profit from daily market movements in the prices of securities and not from dividends, interest, or capital appreciation,
- Your trading activity is substantial, and
- You carry on your activity with continuity and regularity.

The Service considers facts and circumstances to determine if your activity is a securities trading business:

- Typical holding periods for securities bought and sold,
- The frequency and dollar amount of your trades during the year,
- The extent to which you pursue the activity to produce income for a livelihood. and
- The amount of time you devote to the activity.

If your trading activity does not constitute a business, you are an investor, not a trader. In the alternative, you are an investor if you typically buy and sell securities and expect income from dividends, interest, or capital appreciation.

---

[18] The effectiveness of the Loss Harvesting tactic depends on 1) your anticipated marginal tax rate for both the current and the next year 2) the expected pattern of gains and losses for next year as well as this year, 3) the availability of offsets in the current and next year, and 4) anticipated changes to the tax code next year. We have yet to see a list of "Ten Things You Can Do Before Year End to Lower Your Tax Bill" that acknowledges even one of those variables.

As with most tax distinctions, it does not matter what you call yourself: facts and circumstances determine whether you are a trader or an investor.

You may, in fact, be a trader in some securities (e.g. options) and may hold other securities (e.g. equities) for investment. Trader rules do not apply to the securities held for investment (or vice versa). You must keep detailed records to distinguish securities held for investment from the securities in the trading business. {Securities held for investment must be identified as such on the day you acquire them. One way to accomplish this is to hold them in a separate brokerage account.}

[ii] Corrective reporting for 1099B errors.