Options Newsletter for Investment Advisors

TMX Montréal Exchange

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Using Options to Defer Taxes

Year-end is just around the corner and it is time for investors to review and adjust their portfolios. Variations in the stock market throughout the year created investment opportunities for investors, resulting in profits on some stocks and losses on other stocks. Selling winning stocks (stocks with profitable positions) will result in capital gains and trigger a tax liability. Astute investors will also sell stocks with losing positions to reduce as much as possible the tax impact on the portfolio. However, what makes sense from the point of view of tax strategy may in fact turn out to be disastrous for the point of view of investment. It is possible that certain stocks with losing positions should be kept in the portfolio because of the potential for price appreciation in the future, while some winners should be sold for opposite reasons. To rely on the sole purpose of neutralizing the tax impact of a portfolio may negatively impact the portfolio's returns in the future. However, investors can use options judiciously to reduce the tax impact linked to the year-end review and rebalancing[1] of their portfolios.

TAX TREATMENT OF STOCKS WITH PROFITABLE POSITIONS

Following the stock market rally since October, many stocks are showing respectable profits and selling them may trigger a tax liability for the current tax year. An investor may choose to defer this year's unrealized profits to the next year for two reasons: 1) because there are no losses (stocks with losing positions) in the portfolio that can be offset against the winners, and 2) because the winners (stocks with profitable positions) still have the potential for additional price appreciation in the future.

In such a situation, an investor who does not want to sell the shares during the current tax year will have to find an alternative strategy to keep the shares while protecting, in parts or in whole, the profits accumulated. The purchase of put options is the perfect tool to accomplish this objective. Let's look at the following example where an investor holds 1,000 shares of Bank of Montreal (BMO) purchased at $56 on August 8, 2011. At the current price of $59.76, there is an unrealized profit of $3,760 that the investor would like to protect. The investor would also like to profit from any additional price appreciation in the future. Put options expiring in January 2012 with a strike price of $60 are available at $1.93 per share[2]. The purchase of ten put options, for a total cost of $1,930, would guarantee the investor a selling price of $60 for their 1,000 shares anytime up until the expiry of the contracts in January 2012. As a result, the investor is guaranteed to keep close to half of the $3,760 unrealized profit while being able to take advantage of any additional stock price appreciation in the coming months.

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[1] It is strongly recommended that investors consult their tax advisors before implementing tax deferral strategies.

[2] Average price between the bid and ask as of October 28, 2011. Commissions are not included.

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At the expiration of the put options in January, two scenarios are possible:

1. BMO is trading at $66
2. BMO is trading at $56

Scenario 1: BMO is trading at $66

If BMO is trading at $66, the investor has no obligation to exercise the put options and sell the shares at $60 since buying options is a right and not an obligation. As a result, the investor will let the put options expire worthless and will rather sell the shares at the market price of $66. By doing so, the investor will kill two birds with one stone. The investor will have succeeded in selling the shares at a higher price compared to the price that the shares were trading at in October; and the investor will have deferred the taxes on the capital gain to the 2012 tax year. The actual realized profit is now $10,000 (($66 - $56) x 1,000 shares) minus the premium of $1,930 paid to buy the put options for a net profit of $8,070. This profit will be considered as a capital gain for the 2012 tax year.

Scenario 2: BMO is trading at $56

If BMO is trading at $56, the investor will be able to sell the shares at the strike price of $60 by exercising the put options. By doing so, the investor will have protected part of the profits and will defer them to the 2012 tax year. The actual realized profit is now $4,000 (($60 - $56) x 1,000 shares) minus the premium of $1,930 paid for the put options for a net profit of $2,070. The profit is much larger compared to the profit that would have been realized had the investor waited to sell the shares in January 2012 without using put options since the share price returned to its August level—wiping out all the profits.

We can see that using put options allows, in all cases, to defer successfully, in part or in whole, profits from one tax year to the next.

REDUCING THE COST OF HEDGING

The purchase of put options can be very expensive. When an investor is concerned about the cost of using put options, the investor may decide to sell call options and use the premium received to reduce the cost of the put options. This options strategy is called a collar. Using the previous example on BMO, the investor may sell call options expiring in January 2012 with a strike price of $60 at a price (premium) of $1.75 per share. The premium of $1,750 received from the sale of ten contracts will be applied against the $1,930 paid to buy ten put options expiring in January 2012 with a strike price of $60. The total cost of the collar strategy is $180. With this position, the investor would be guaranteed to sell the shares at a price of $60 regardless of the price of BMO at the expiry of the options in January 2012. If the price of BMO is above $60 at the expiration of the options, the investor will have to sell the shares following the exercise of the call options by the holder (the buyer of the call options), and the put options will expire worthless. As a result, the $180 ($0.18 per share) net cost of the options strategy will reduce the net selling price for the BMO shares to $59.82 ($60 minus $0.18). On the other hand, if the price of BMO is lower than $60 at the expiration of the options, the investor will exercise the put options and sell the shares at $60 minus the net cost for the options strategy for a net selling price for the BMO shares of $59.82.

We can see that the collar strategy allows to lock-in a sale price for the shares regardless of the price of the shares at the expiration of the options.

TAX TREATMENT OF STOCKS WITH LOSING POSITIONS

We will now examine how an investor can manage stocks with losing positions in order to take advantage of the fact that, for tax purposes, it is possible to deduct losses from gains realized in the same tax year, while having the possibility to recoup, in part or in whole, the losses in the following tax year. Suppose an investor bought 1,000 shares of Research in Motion (RIM) at a price of $25 on October 6, 2011, now trading at $21.17 at the close of the market on October 28, 2011. The unrealized loss (loss on paper) is $3,830. The investor would like to use the loss for the 2011 tax year in order to reduce the capital gains accumulated this year. However, the investor still thinks that the price of RIM shares will recover and will eventually be higher than the original $25.

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By selling the shares immediately, the investor faces the risk of not being able to participate in any additional price appreciation that may materialize. On the other hand, if the investor waits until the end of the year to sell the shares, RIM shares could continue to decline and losses would increase. The solution to this is to sell immediately RIM shares at $21.17 in order to realize the loss for the 2011 tax year and simultaneously buy ten call options expiring in January 2012 with a strike price of $21 at a price (premium) of $2.93 per share for a cost of $2,930. The purchase of ten call options gives the investor the right to buy 1,000 shares of RIM at $21 until the expiration of the call options in January. If the price of RIM shares rally back to $25 or higher, the investor will recoup all the losses and even realize a profit.

At the expiration of the call options in January, two scenarios are possible:

1. RIM is trading at $31 (the price on September 1, 2011)
2. RIM is trading at $11 (if everything goes wrong)

Scenario 1: RIM is trading at $31

If RIM is trading at $31, the investor may either sell the calls at the intrinsic value of $10, or exercise the calls in order to buy the shares at the strike price of $21 if the investor chooses to keep the shares in the portfolio. The sale of the ten call options at a price (premium) of $10 per share would generate a profit of $7,070 ($10 x 1,000 shares less the premium paid of $2,930). By selling the shares in 2011 the investor realizes the loss in the 2011 tax year whereas the gains on the call options will be realized in 2012.

Scenario 2: RIM is trading at $11

If RIM is trading at $11, the investor has no obligation to exercise the call options and buy the share at $21 since buying options is a right and not an obligation. As a result, the investor will let the options expire worthless and buy the shares in the market at $11 if the investor believes that the price of RIM shares will rise in the future. The loss of $2,930 represents the cost to buy the call options and is by far smaller than the loss of $10,000 the investor would have incurred if the shares were kept.

We can see that the use of call options allows selling shares with a losing position in the current tax year while being able to take advantage of any potential price appreciation in the future. Furthermore, losses are limited to the premium paid for the call options, reducing the risk of holding the shares.

Options are not only used to speculate on a view of the direction of prices, they can also be used to lock-in a purchase price or a selling price, in anticipation of an upcoming purchase or sale. The use of put options gives investors the opportunity to defer capital gains to the next tax year and at the same time provides the investor the flexibility to sell the shares at the current price and participate in any price appreciation that may arise in the future. The sale of call options gives investors the opportunity to finance, in part or in whole, the purchase of put options and allows an investor to lock-in a sale price as well. However, the lower cost of the options collar strategy limits the potential profit that may arise if the price of the shares rises in the future. All these strategies offer the flexibility that investors may need in order to rebalance their portfolios while reducing the tax impact that may arise from the sale of shares.

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