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IRS Short Selling Rules Can Be A Taxing Matter

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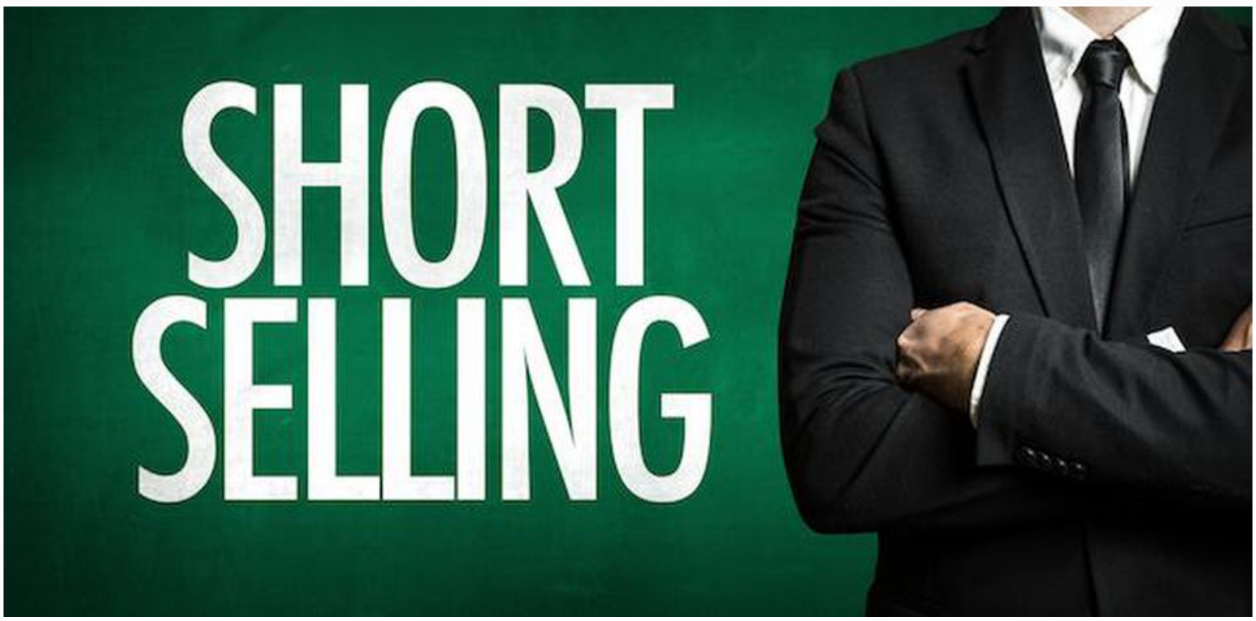

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The essence of trading is buying and selling financial products for income. If you think the asset will rise in value, buy first and sell afterward — this is what's known as a "long position." If you want to speculate on the asset declining in value, borrow the security to sell it first, and buy it back later to close the short position — this is "selling short." (There are other ways to speculate on market drops like buying put options or inverse ETFs, both of which are long positions.)

In this blog post, I cover the tax treatment for selling short. There are two types of short sales: (1) a short sale and (2) a short sale against the box. Both involve borrowing securities from another account holder, arranged by a broker.

Constructive sales on appreciated positions

In the old days, owners stored stock certificates in safe deposit boxes. They could borrow and sell securities, but not the ones stored in their box — hence the moniker, “short sale against the box.” It became a popular tax shelter to defer capital gains taxes.

The Taxpayer Relief Act of 1997 mostly closed the deferral loophole by adding new Section 1259 Constructive Sales Treatment For Appreciated Financial Positions. Before these changes, a trader could own security A with a large unrealized capital gain and short it against the box before year-end to economically freeze the capital gain, but defer realization of the capital gain until the following year. Exception: A trader can still achieve tax deferral on an open short against the box position at year-end if he buys to cover the open short position by Jan. 30 and leaves the long position open throughout the 60-day period beginning on the date he closes the transaction — so there is an economic risk.

An example from Pub. 550 Investment Income and Expenses, Short Sales:

“On May 7, 2015, you bought 100 shares of Baker Corporation stock for $1,000. On September 10, 2015, you sold short 100 shares of similar Baker stock for $1,600. You made no other transactions involving Baker stock for the rest of 2015 and the first 30 days of 2016. Your short sale is treated as a constructive sale of an appreciated financial position because a sale of your Baker stock on the date of the short sale would have resulted in a gain. You recognize a $600 short-term capital gain from the constructive sale and your new holding period in the Baker stock begins on September 10."

The constructive sale rules apply on substantially identical properties, which includes equities, equity options (including put options), futures and other contracts. For example, Apple equity is substantially identical with Apple call and put equity options. Traders use a bevy of financial products, and they may inadvertently trigger Section 1259 constructive sales. Report gains on constructive sales, not losses.

Brokers do not report constructive sales on appreciated positions on Form 1099-Bs. Traders need to make manual adjustments on Form 8949. I recommend using tax-compliant software or a service provider that uses a tax-compliant software.

Special rules for short-term vs. long-term capital gains and losses

Most traders understand capital gains rules for long positions. For securities using the realization method, a position held for 12 months or less is a short-term capital gain or loss subject to marginal ordinary tax rates (up to 39.6% for 2015 and 2016). A position held for more than 12 months is a long-term capital gain with lower capital gains tax rates (up to 20% for 2015 and 2016).

According to Pub. 550, "As a general rule, you determine whether you have short-term or long-term capital gain or loss on a short sale by the amount of time you actually hold the property eventually delivered to the lender to close the short sale."

If you sell short without owning substantially identical property (stock or option) in your account, the holding period starts when you later buy the position to close the short sale. The holding period is one day, so it's a short-term capital gain or loss. Most investors think selling short is the reverse of going long and the holding period should start on the date you short the security — but that is not the case.

Holding period rules are more complicated when you short against the box. Special anti-abuse rules contained in Section 1233 prevent traders from converting short-term capital gains into long-term capital gains and long-term capital losses into short-term capital losses. Read the "Special Rules" in IRS Pub. 550.

Dividends and "payments in lieu" of dividends

When traders borrow shares to sell short, they receive dividends that belong to the lender, the rightful owner of the shares. After the short seller receives these dividends, the broker uses collateral in the short seller's account to remit a "payment in lieu of dividend" to the rightful owner to make the lender square in an economic sense. But there are complications which may lead to higher taxes.

Dividend issues for the short seller

If a short seller holds the short position open for 45 days or less, add the payment in lieu of dividend to cost basis of the short sale transaction reported on Form 8949 (realization method) or Form 4797 (Section 475 MTM method). Watch out for a capital loss limitation. (Traders with trader tax status using Section 475 are not concerned as they have ordinary loss treatment.)

If a short seller holds the short sale open for more than 45 days, payments in lieu of dividends are deductible as investment interest expense. Report investment interest expense on Form 4952. Watch out, because the current year tax deduction is limited to net investment income, which includes portfolio income, minus investment expenses. (See Form 4952 instructions.) Carry over disallowed investment interest expense to the subsequent tax year(s). With itemized deduction limitations, some short sellers come up short on investment interest expense deductions. (If a short seller holds the short sale open for more than 45 days, in connection with a trading business with TTS, payments in lieu of dividends are deductible as business expenses.)

Dividend issues for the lender

When investors sign margin account agreements, few realize they are authorizing their broker to lend their shares to short sellers. Instead of issuing the account owner (lender) a Form 1099-DIV, which may include ordinary and qualified dividends, the broker issues a Form 1099-Misc or similar statement for “Other Income.” The lender forgoes the qualified dividends tax break on common stock held at least 60 days. Lower capital gains rates apply on qualified dividends.

Lenders report this substitute dividend payment as “Other Income” on line 21 of Form 1040. Don’t overlook including substitute dividends in investment income entered on Form 4952 used to limit investment interest expense. Some brokers offer to compensate lenders for losing the qualified dividend rate. Institutional or large stock lenders may earn credit interest on lending out their shares.