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Tax Deferral Strategies

For years up until the burst of the bubble, investors needed only to be right about which stock to buy. Should they buy XYZ, ABC or PDQ? The philosophy at the time led investors to believe that the purchase was the key to success. The question was not "which stock will go up?" but "which stock will go up more?" It was a time of buy and hold and the concept of *sell* was often overlooked and infrequently used.

This remarkable bull market phase was characterized by large moves, and also by some degree of investor complacency – in that they just bought, held, and waited.

When the bubble burst, stocks became much more volatile, making it too dangerous to just buy, hold and wait. As quickly as an investor had a profit, the market could turn and they would suddenly be faced with a loss. The time of buy and hold had ended and the time of buy and sell had begun.

The importance of taking a quick profit now meant the difference between profit and loss. The shrewd investor took profits quickly, instead of waiting and having those profits disappear. However, one of the problems investors then faced was higher taxes, in the form of short term capital gains.

Investors who sold their stock before holding for a one year period were hit with these higher short term capital gains taxes. Short term capital gains are treated as ordinary income thus taxed at that rate which for most investors is 25%. That tax is much higher than the long term capital gains tax of 15%, up to 67% higher.

Prior to the burst of the bubble, an investor was pretty safe holding onto an investment for a few extra months in order to get beyond the one year mark. Then they would sell their position and only incur the long term capital gain tax, which today is 15%.

These days, it can be dangerous even waiting a couple of extra days, let alone weeks or months. That delay can mean the difference between having to pay taxes or finding a previous gain to put against your new loss.
Fear not investor … Options to the rescue! As we have established in "The Stock Replacement Covered Call Strategy," a deep in-the-money call

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can be substituted for stock under appropriate conditions. In the Stock Replacement Covered Call, you used the purchase of a call with a delta in the mid to high 90's to replace your long stock. As you saw, the call behaved very similarly to a long stock position.

In this case, you will again use a deep-in-the-money call to replace your stock. This time, however, you will engage in a sale of the call to mimic the sale of the actual stock. With proper timing and call selection, you can hold on to the stock until the one year time line passes without risking the potential decrease in your profit. Let's take a look at how this works.

We begin our analysis by walking through an example. Let's pretend that you bought stock XYZ at a price of $45.00 in January 2003. Over the course of the next nine months, XYZ traded up to $82.00. At this point (October - the ninth month of ownership), you feel that it is time to take your profit and sell your stock.

However, since it has only been nine months since the purchase, you would be susceptible to the higher tax on your short term capital gains. But, by waiting another few months, you run the risk of the stock trading down and losing profits.

If you sell the stock, you lose additional money because of the difference between short term (15%) and long term (25%) capital gains taxes. If you wait out the year, you risk the decrease in the stock price. What should you do?

The best solution would be to *sell a call option* against your stock.

For more Information about option trading, please click here:
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