



## [Tax Deferral Strategies](#)

### **Sell a call option:**

To capitalize on this strategy, your call must meet certain criteria. First, the time to expiration should be just beyond the stock's one year ownership time period. You need to get beyond the one year period but not too much beyond so you are not tied into the position longer than you have to be.

Remember, you are engaging in this strategy because you want to sell the stock and close the position, so you want to stay away from doing anything that would keep you in the position longer than absolutely necessary.

Second, you would want to make sure the option is deep enough in-the-money, in two respects. First, the option must have a high delta, at least in the 90's, and second - the strike price must be lower than what you perceive is the lowest price the stock could reasonably go between now and the option's expiration.

So, you decide to sell the January 2004, 60 strike calls for \$23.00. By doing this, you have ensured yourself of being able to sell the stock at \$60.00 and you have received \$23.00 to do so. In effect, you have sold your stock at \$83.00 without selling your stock, as long as the stock stays above \$60.00 by the expiration. This is because the buyer of the option will naturally exercise your short call with the stock above \$60.00 forcing you to sell the stock to them. You then sell your stock at \$60.00 plus the \$23.00 you received from the sale of the option.

Because this happens at January expiration, which is after the one year time line, you now only have to pay long term capital gains tax - instead of the much higher short term capital gains tax.

You see what happens when the stock stays above \$60.00, but what happens when the stock trades below \$60.00? Below \$60.00, the buyer of your call will not exercise their call. Under those circumstances, you must sell the stock yourself. You will realize whatever the market price of the stock is at that time plus the \$23.00 you received from the sale of the call.

Another strategy that would provide you the protection you need, while buying you the time you need would be a collar. A collar, however, can

cost you money because the collar involves the trading of two options, and therefore costs you more in commissions.

We have discussed the collar strategy in your Home Study Guide. When applying the collar to this situation, make sure you choose an expiration month that is beyond the one year time period from the purchase date of your stock. Before you make a final decision on selling a deep in-the-money call to avoid short term capital gains tax, make sure you check out the collar and compare its suitability against the call sale strategy to see which is better for you.

As you can see from our example above, the sale of a deep in-the-money call can buy enough time and protection for you to artificially extend your stock position with minimal risk. If employed properly, the [Tax Deferral Strategy](#) can save you many thousands of dollars in saved taxes. The next time you have profits in a long stock position that you've had for nine months or more, consider using this strategy to lock in your profits – and save money on your taxes.

**Note:** Be sure to talk to your broker and your accountant about this strategy before employing it. Tax laws change regularly, as you can see, and you should check with an expert to make sure this strategy is still viable. It is important to consult with a professional accountant or tax attorney before employing any of these strategies to see which is currently acceptable with the IRS.

**Update:** At the time of this writing, we have heard that the IRS may be changing their policy on this strategy and may consider this a 'wash sale.' This essentially means that the sale of a call in this manner would constitute a sale of the stock, and that you would still be liable for the short term capital gains on the trade. This means. In reality, the IRS is stating that the stock was effectively sold on the date the call was sold and not on the expiration date of the call.

If the IRS will not let us use in-the-money options or at-the-money options for tax deferral, then we must find a way to use out-of-the money options to lock in the stock price for the period of time necessary to meet the long term gain requirement, as in the case of the collar strategy.

As you recall, the collar combines the purchase of an out-of-the-money put, with the sale of an out-of-the money call. The proceeds of the call sale will be used to off set the cost of the put and thus, the total outlay of capital will be minimal.



Looking back at the earlier example, we will now apply a collar to protect our position price, and buy us time until the one year mark passes.

As you remember, we were talking about a stock, XYZ, which we purchased in January of 2003 at a price of \$45.00. By October of 2004, the stock had increased in price to \$82.00. If you wanted to sell your stock and take your profit at this time, you would have to pay the higher short term capital gains tax.

This means your profit will be taxed as ordinary income. Now if you could get the stock to hold steady for a few more months, you could sell and only incur the long term capital gains tax, which could be a big savings to you.

Let's take a look at how to properly implement the collar here. With the stock at \$82.00, you would purchase the January 2004 80 strike put and sell the 85 strike call. Hopefully, you can execute this trade for no cost, but, in all likelihood, you'll have to pay a small premium for the position (which would be well worth it).

Now that you have the January 80-85 collar on, let's take a look at how the position would work based on where the stock goes.

For more Information about option trading, please click here:  
[www.options-university.com](http://www.options-university.com)