

December 2015

The Trade Date Rule

The tax law is like, well, death and taxes – you can run from it, but you cannot hide. This time of year, as buy-side funds, insurance companies, and individual investors seek to harvest built-in taxable losses, they need to pay attention to the trade date rule. This is the rule that governs whether gain or loss from the disposition of a security is taken into account on the trade date or the settlement date.

Securities trades do not clear instantaneously. Money and property do not exchange hands when a buyer clicks “Buy,” and when a seller clicks “Sell.” Instead, on that date (the trade date), the buyer enters into a forward contract to buy, and the seller enters into a forward contract to sell, the underlying security. Securities and money are transferred on a later date (the settlement date). For securities traded on U.S. equity exchanges, the settlement date is usually three business days after the trade date (T+3), and for bonds, the settlement date is usually one business day after the trade date (T+1). Although gain or loss is “locked in” as of the trade date, the transaction does not close until the settlement date.

So – your client has \$1m of capital loss carryforwards that are going to expire on Dec. 31, 2015. It has \$5m worth of portfolio stock, with \$1m of built-in gain. It hits “sell” at 3:55 on Dec. 31, 2015. If gain from the sale is taken into account in 2015, it will be offset by the capital loss carryforwards, and gain will be tax-free. By contrast, if it is taken into account in 2016, the carryforwards will evaporate, and your client will owe \$200,000 (\$396,000, if the shares were held for less than a year) to the government on April 15, 2017. Which is it?

It depends. Under general federal income tax principles, gain or loss from a forward contract is not recognized when the forward contract is entered into; instead, it is recognized when the contract is closed. If this rule were to apply to the present case, gain or loss would not be recognized until the settlement date. Since this would most likely be Jan. 4, 2016, shouldn't your client be out of luck?

In many cases, no. This is because the Internal Revenue Service (IRS) has taken the position that, *contra* the general rule, in regular-way trades placed on an exchange, securities are treated as being disposed of, and gain or loss recognized, on the trade date, rather than on the settlement date. Some practitioners and commentators (including the current author) feel that this position rests on a faulty interpretation of earlier case law and regulatory guidance – but it is settled government practice, and taxpayers rely on it.

The foregoing applies to “long” sales only. Short sales are different. By way of background – when a taxpayer sells a share short, he borrows the share from his broker and sells it to a third party. Proceeds from the sale are held in his account, and he is obligated to return identical shares (although not the same shares) to the broker in order to close, or “cover” his short position. A taxpayer will generally cover a short position by placing a regular-way trade to buy shares of the stock that he borrowed to open the short position. As with any other regular-way trade, this transaction will generally settle three days after the trade date. Therefore, although the taxpayer has locked in his gain or loss from the short sale as of the trade date, he will not have securities to deliver to his broker until the settlement date. Courts and the IRS have long held (and still hold) that, since a short seller’s obligation to deliver shares to a securities lender is not extinguished until shares are actually delivered, a short position is not closed until the settlement date of the covering trade. This means that, in contrast to the treatment of long sales, gain or loss from a short sale is generally not recognized until the *settlement* date.

There is an exception to the foregoing rule. In the late 1990s, Congress and the IRS learned that taxpayers had been monetizing positions in high-value, low-basis stock tax-free by entering into “short-against-the-box” transactions. In a transaction of this type, a taxpayer holding shares with built-in gain would sell identical shares short, and deliver the already-owned shares to their securities lender to be held in a separate account (in the box) as security for their obligation to cover. Under law that existed at the time, gain from the short sale would only be recognized when the shares in the box were delivered to the securities lender. To combat perceived abuse, Congress passed Code section 1259. *Inter alia*, Code section 1259 requires that a taxpayer who holds a short position that has appreciated in value recognize built-in gain therefrom when it acquires property substantially similar to the property underlying the short position. In subsequent guidance, the IRS has held that, for these purposes, shares purchased to cover a short position in a regular-way trade are “acquired” on the trade date. Therefore, gain from a short position is recognized on the trade date of the covering transaction, while loss from a short position is recognized on the settlement date.

Where does that leave your client? Potential outcomes can be summarized as follows:

Table 1: Timing of Gain and Loss from Regular-Way Trades

	Gain	Loss
Long	Trade Date	Trade Date
Short	Trade Date	Settlement Date

When in doubt regarding end-of-year tax planning strategies, the prudent path is to consult a tax adviser.

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