REPORT # 540

TAX SECTION

New York State Bar Association

Committee on Commodities and Financial Futures

Report on a Legislative Proposal on the
Federal Tax Treatment of Certain Transactions
Involving Listed Option Contracts

July 18, 1986

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TAX SECTION

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Attached letter dated 7/22/86 enclosing report of the Commodities and Financial Futures Committee regarding a legislative proposal on the Federal tax treatment of certain transactions involving listed option contracts sent to the following:

The Honorable Dan Rostenkowski
cc: The Honorable John J. Duncan
Robert J. Leonard, Esq.

The Honorable Bob Packwood
Chairman
Senate Finance Committee
cc: The Honorable Russell B. Long
John Colvin, Esq.

The Honorable J. Roger Mentz
Assistant Secretary (Tax Policy)
Department of the Treasury

The Honorable David H. Brockway
Chief of Staff
Joint Committee on Taxation

REPORT # 540

TAX SECTION

New York State Bar Association

July 22, 1986

The Honorable Dan Rostenkowski
2232 Rayburn Building
Washington, DC 20515

Dear Representative Rostenkowski:

The enclosed report, prepared by the Committee on Commodities and Financial Futures of the Tax Section of The New York State Bar Association, addresses the legislative proposals of the Chicago Board Options Exchange, Inc. on the Federal tax treatment of certain transactions involving listed options contracts. These proposals are embodied in S. 2086, introduced by Senator Simon.

The proposals relate to (i) modification of the definition of "qualified covered call" to substitute an across-the-board 15 percent in-the-money standard; (ii) expansion of 60 percent long-term, 40 percent short-term capital gain (loss) treatment to options on individual stocks (and a narrow based index options); (iii) creation of an exception to the straddle rules for married puts and similar transactions; (iv) the creation of an options dealer account that would provide a special 37 percent rate of tax for options dealers; and (v) technical modifications to sections 263(g) and 263(h) of the Internal Revenue Code.

The report makes a number of technical and policy comments regarding the proposals.

The report supports the proposal to create an exception to the straddle rules for married puts and similar transactions. Such a change could be implemented through an amendment to the existing regulations. The report also comments on the proposed modification to section 263(g)(2)(B) on the receipt of compensation for property used in a short sale. A change in this area is contained in both the House and Senate versions of H.R. 3838; the report notes, however, that the change contained in the bills is too narrow in scope, and recommends that the scope of the change be broadened.

Certain issues discussed in the report would be mooted if the preferential treatment for capital gains of individuals (and section 1256 contract gains) were eliminated as provided in the Senate bill. The report does not comment on these fundamental changes.

I hope that the report is useful to you.

Sincerely,

Richard G. Cohen
Chairman

Enclosure
cc: The Hon. John J. Duncan)with
Robert J. Leonard, Esq.)enclosure

REPORT #540

New York State Bar Association

Tax Section

Committee on Commodities and Financial Futures

Report on a Legislative Proposal on the Federal Tax Treatment of Certain Transactions Involving Listed Option Contracts

July 18, 1986

I. Introduction[1]

A. Background

In January 1986, the Chicago Board Options Exchange, Inc. (“CBOE”) submitted to the Congress and the Treasury Department a series of proposals for changes in the Federal income tax treatment of transactions involving listed option Contracts.[2] These proposals are embodied in S. 2086, introduced by Senator Simon.[3]

This Report contains an analysis of the CBOE Proposals. The Report was prepared after the Treasury Department indicated an interest in receiving comments on the Proposals.

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[1] This Report was written by Richard L. Reinhold with the assistance of Michelle P. Scott, Thomas A. Humphreys and Greer L. Phillips. Helpful comments were received from Dale S. Collinson, James B. Farley, Donald Schapiro and Ralph O. Winger.

[2] See Legislative Proposal for Simplification of the Taxation of Listed Option Contracts, dated January 17, 1986, submitted on behalf of the Chicago Board Options Exchange, Inc. (the “CBOE Proposals” or simply “Proposals”). The CBOE Proposals were amended by a memorandum, dated January 24, 1986, submitted to the Treasury Department ("Addendum").

[3] 99th Cong., 2d Sess. (1986) (“S. 2086”).

B. Senate Amendments to H.R. 3838

Since the submission of the CBOE Proposals, the Senate adopted amendments to H.R. 3838[4] that would make sweeping changes to the Federal tax system through the significant reduction of individual tax rates and the broadening of the tax base through elimination of many deductions, credits and preferences. Of particular significance in the present context is (i) the elimination of the deduction for 60% of long-term capital gains in the case of individuals, and (ii) the substitution of 100% short-term capital gain and loss treatment for section 1256[5] contract gains and losses in lieu of the 60% long-term/40% short-term treatment presently provided. Adoption of these measures would in several cases significantly affect (and in some cases render moot) issues discussed in this Report. This Report makes no recommendation as to the advisability of these fundamental changes in the tax treatment of long-term capital gains and losses. Except where stated to the contrary, however, the Report assumes that a preferential rate of tax will be retained in the law for long-term capital gains and section 1256 contract gains.

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[4] 99th Cong., 2d Sess. (1986) ("H.R. 3838").

[5] Except as noted, section references herein Internal Revenue Code of 1954, as amended.

C. Summary of CBOE Proposals

The CBOE Proposals are divided into five groups:

(i) Qualified covered calls. The exemption from the tax straddle rules for "qualified covered call" transactions would be amended by (A) substituting a single numerical test -- 85% of the applicable stock price -- for the various "bench marks" presently provided to determine whether a call option is "deep-in-the-money"; (B) expanding the restriction on the deductibility of year-end losses that presently applies where the option position is closed out at a loss shortly prior to the stock position (and the stock gain is recognized in a later year) to situations in which the stock is sold at a loss, and the option position is terminated shortly thereafter, with gain recognized in a later year; and (C) repealing the recharacterization rule that treats losses on a qualified covered call as long-term when gain on the offsetting stock position would be long-term. These proposals are discussed at pages 9 through 25.

(ii) Expansion of 60/40 treatment. The Proposals would expand "section 1256 contract" treatment to "pure" equity options held by investors, including both options on single stocks and options on narrow-based stock

indices. Presently, options granted by an investor always result in short-term gain or loss; and options purchased by an investor produce short-term or long-term gain or loss, depending on the taxpayer's holding period for the option. Under the Proposals, "pure" equity options that are exchange-traded (A) would be treated as sold on the last day of the holder's taxable year; and (B) would receive 60% long-term gain (loss)/40% short-term gain (loss) treatment, regardless of actual holding period, and regardless of whether the taxpayer is the grantor or holder of the option. Section 1256 contract treatment would not be provided, however, in cases in which an equity option was part of a mixed straddle -- i.e., the equity option was part of a straddle including a position that was not a section 1256 contract, such as stock. These proposals are discussed at pages 26 through 35.

(iii) Exception to straddle rules for "married puts", etc. The Proposals would provide an exception to the holding period termination rule applicable to positions of a straddle for positions constituting a married put, married call or married straddle, similar to the exception now applicable under section 1233(c). These proposals are discussed at pages 35 through 53.

(iv) Create options dealer account. The Proposals would allow dealers in options to create an "options dealer account". Although similar to the "mixed straddle account" presently provided in the Code and Treasury regulations, several restrictions imposed in connection with mixed straddle accounts would not apply. In addition, a maximum 37% rate of tax would apply for gains realized by individuals through these accounts. These proposals are discussed at pages 53 through 59.

(v) Sections 263(g) and 263(h). The Proposals would allow options dealers and commodities dealers to deduct net capital losses against ordinary income in order to provide relief from the requirement that interest and carrying charges be capitalized under section 263(g). Several technical changes also would be made to sections 263(g) and 263(h). These proposals are discussed at pages 59 through 74.

D. General Summary of Tax Straddle Rules

The tax straddle rules of the Code were first enacted as Title V of the Economic Recovery Tax Act of 1981 ("ERTA"),[6] and were modified significantly by the Deficit Reduction Act of

[6] P.L. 97-34.

1984 (the "1984 Act").[7] There are three principal components of the tax straddle rules:

(i) Loss deferral. Under section 1092(a), losses realized with respect to a position of a straddle may not be taken into account if there is "unrecognized gain" in an offsetting position of the straddle at year-end. In addition, under regulations, losses may not be taken into account if there is unrecognized gain in a "successor" position of the straddle, in order that the previous rule will function if gain in an offsetting position later "migrates" to a position that is similar to the loss position.[8] Disallowed losses carry over for use in following years, but subject to application of the same restrictions in each year. A "straddle" consists of offsetting "positions"; a "position" is an interest in personal property of a type which is actively traded.[9] In general, positions are offsetting if ownership of one position results in a substantial diminution of the risk of loss with respect to another position.

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[7] P.L. 98-369.

[8] Treas. reg. section 1.1092(b)-IT(a).

[9] Section 1092(c)(l), (d)(l), (d)(2).

(ii) Marking-to-market; 60/40 treatment. Section 1256 contract treatment is provided for specified instruments. Under section 1256, (A) contracts held on the last day of the taxpayer's tax year are treated as sold for their fair market value ("marked to market") with resulting gain or loss taken into account, and (B) gain or loss with respect to such contracts is treated as 60% long-term and 40% short-term.[10] Section 1256 contract treatment is provided for regulated futures contracts, certain foreign currency contracts, listed options with respect to property other than stocks (but including broad-based equity options), and equity options of dealers in such options.[11] The year-end marking to market under section 1256 obviates the need for determining the existence of straddles and application of the loss deferral rule described in (i), above, if positions other then section 1256 contracts ("non-section 1256 contracts") are not part of the straddle; thus, in such cases, an exception to those rules is provided.[12]

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[10] Section 1256(a). The blended 60% long-term, 40% short-term treatment provided for futures contracts in ERTA represented a compromise tax rate designed to take into account the potential acceleration of tax as a result of year-end marking to market, and possibly other factors.

[11] Section 1256(b).

[12] Section 1256(a)(4).

(iii) Section 263(g). Section 263(g) requires the capitalization of net interest and carrying charges related to positions of a straddle. The rule is designed to prevent the deduction of current expenses that are economically counterbalanced by accretion in value of an asset that will be recognized only on disposition of the asset, usually at capital gains rates.

There are two general exceptions to the straddle rules described above: first, hedging transactions, properly identified, are excepted, although "syndicates" that involve a more than 35% allocation of losses to limited partners or limited entrepreneurs may not claim the hedging exemption.[13]

Second, an exemption from the straddle rules is provided for straddles consisting only of (A) one or more "qualified covered call" options granted by the taxpayer and (B) stock to be purchased from the taxpayer pursuant to such opt ions.[14] In general, a qualified covered call is a listed option granted by the taxpayer that is not "deep-in-the-money".[15]

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[13] Sections 263(g)(3), 1092(e), 1256(e).

[14] Section 1092(c)(4)(A).

[15] Section 1092(c)(4)(B).

II. Description and Discussion of CBOE Proposals

1. Revision of Qualified Covered Call Rules

A. Present Law

Straddles that consist solely of one or more "qualified covered call" options granted by the taxpayer and the stock to be purchased from the taxpayer pursuant to such options are not, treated as straddles for purposes of sections 1092 and 263(g).[16] To constitute a "qualified covered call" option, an option must satisfy each of the following conditions:

(i) The option must be granted by the tax-payer to purchase stock held by the taxpayer or acquired by the taxpayer in connection with the granting of the option.

(ii) The option must be traded on a national securities exchange that is registered with the Securities and Exchange Commission (i.e., a listed option) or other market that the Secretary of the Treasury determines has rules adequate to carry out the purposes of section 1092(c)(4).

(iii) The option must be granted more than 30 days prior to its expiration date.

(iv) The option must not be a "deep-in-the-money" option.

[16] Section 1092(c)(4)(A).

(v) The option must not be granted by an options dealer in connection with his activity of dealing in options, and gain and loss with respect to the option not produce ordinary income or loss.[17]

An option is considered deep-in-the-money if its "strike price" is lower than the "lowest qualified bench mark".[18] The lowest qualified bench mark is the "highest available strike price" that is lower than the "applicable stock price".[19] The "applicable stock price" is defined as (x) the most recent prior trading day's closing price for the stock, or (y) the opening price for the stock on the day the option is granted, but only if that price is greater than 110% of the prior trading day's closing price.[20] Thus, subject to certain exceptions, a call option will not be considered deep-in-the-money the strike price of the option is not more than one "bench mark" below the then current trading price of the stock. The "bench marks" referred to in the statute correspond to the strike prices for listed options fixed on United States option exchanges.[21]

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17 Section 1092(c)(4)(B).

18 Section 1092(c)(4)(C).

19 Section 1092(c)(4)(C).

20 Section 1092(c)(4)(G).

21 Prior to January 1985, (i) in the case of stocks trading below $100, options were offered at $5 intervals or "bench Marks", and (ii) in the case of stocks trading at $100 and above, options were offered at $10 intervals. Starting in January 1985, (i) options were offered at $2.50 intervals on stocks trading under $25, and (ii) options were offered at $5 intervals on stocks trading at prices between $100 and $200. To the extent not modified, however, prior rules continue in effect.

Three special rules further refine the definition of “deep-in-the-money” options. First, in cases involving an option having more than 90 days to expiration and a strike price in excess of $50, the highest available stock price is reduced to the second highest available bench mark below the applicable stock price.[22] Second, if the applicable stock price is $25 or less, the lowest qualified bench mark may not be less than 85% of the applicable stock price.[23] Third, if the applicable stock price is $150 or less, an option will be deep-in-the-money if it is more than $10 in-the-money.[24] The Secretary of the Treasury is granted authority to modify' the foregoing rules if appropriate to accommodate changes in the practices of the option exchanges or to prevent tax avoidance.[25]

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[22] Section 1092(c)(4)(D)(ii).

[23] Section 1092(c)(4)(D)(iii).

[24] Section 1092(c)(4)(D)(iv).

[25] Section 1092(c)(4)(H).

The general exclusion of stock and non-deep-in-the-money covered calls from the straddle rules proceeds from the recognition that "[t]he granting of a covered call option does not substantially reduce a taxpayer's risk of loss with respect to the underlying stock unless the option is deep-in-the-money".[26] Without substantial risk reduction, the predicate for application of the straddle rules does not exist. The indicated exceptions to the general rule that a strike price of one bench mark in-the-money was not considered deep-in-the-money were included in the statutory framework to reflect the specific economic characteristics of options that otherwise would provide significant downside risk protection to the holder.

For example, where an option is written close to its expiration, the general one bench mark rule was seen as affording tax-straddling opportunities. Such opportunities arise because (i) virtually the entire option premium reflects the intrinsic worth of the option (i.e., the extent to which the option strike price is less then the stock price) and therefore provides substantial downside risk protection for the stock, and (ii) as an empirical matter, the writer of an option

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[26] Joint Comm. on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 309 (Comm. Print 1984) ("1984 Blue Book").

with a short period to expiration is subject to less risk than the writer of an option with a longer period to expiration. Given this favorable risk/reward ratio, tax straddling is possible since the potential tax advantages to be derived are not outweighed by economic risk in the transaction. Thus, the statute treats as deep-in-the-money any option having 30 days or fewer to expiration.[27]

Two of the straddle rules are made partially applicable to qualified covered call option transactions to forestall tax avoidance opportunities that otherwise could arise notwithstanding that the option is not deep-in-the-money. This diluted application of the straddle rules rests on the premise that a qualified covered call offset by stock represents in effect a "quasi-straddle" to which the straddle rules should be applied on a selective basis, as needed to prevent tax avoidance.

First, any loss on a call position is treated as long-term capital loss if gain on the underlying stock would, at that time, be long-term capital gain.[28] This

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[27] See J. Wetzler, The Tax Treatment of Securities Transactions Under The Tax Reform Act of 1984, Tax Notes, October 29, 1984, pp. 453, 459 n.21 ("Wetzler")

[28] Section 1092(f)(l).

"recharacterization" rule recognizes that if a single market movement simultaneously produces a loss in the call position and gain in the stock, such gain and loss result in an economic "wash". As a result, the principle underlying section 1092(f)(l) holds that the offsetting elements should not be accorded differing tax treatment capable of producing tax arbitrage (i.e., short-term capital loss and long-term capital gain).[29]

Second, the holding period of the underlying stock is suspended (other than for purposes of section 851(b)(3)) during the time that the covered call position is open.[30] This holding period suspension rule is premised on the view that a call that is in-the-money (but not deep-in-the-money) is capable of being used to protect against loss in an appreciated stock position and thereby permit the taxpayer to "age" the holding period of the stock while limiting the taxpayer's exposure to economic risk.

Since both the recharacterization and holding period suspension rules proceed from the assumption that the call position furnishes some degree of protection against downside

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[29] See section 1233(d) for an analogous rule.

[30] Section 1092(f)(2).

risk, and thereby resembles a straddle at least to an extent, the rules have no application if the strike price of the call is not less than the applicable stock price -- i.e., the call is not in-the-money.[31] Where a call is written at or out-of the-money, little or no downside risk protection is provided.

Finally, the loss deferral rule of section 1092(a) is brought into play where (x) a qualified covered call option is closed out at a loss, (y) gain from the disposition of the underlying stock is taxable in a subsequent year, and (z) the stock was not held at risk for at least 30 days following closing of the option position (applying standards of section 246(c)).[32] Again, this partial inclusion of qualified covered call transactions in the straddle rules derives from the view that some straddling potential exists in such transactions.

B. CBOE Proposals

The CBOE first proposes to replace the "deep-in-the-money" call definition of current law with a single standard that would treat an option as deep-in-the-money if its strike price were less than 85% of the applicable stock price. The

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31 Section 1092(f).

32 Section 1092(c)(4)(E).

proposal is advanced on the grounds that the existing rules (i) are overly complex, and (ii) are not self-adjusting, and require action by the Treasury Department (or Congress) to accommodate changes in exchanges' practices in setting option strike prices.[33]

Second, the CBOE would repeal the "recharacterization" rule for qualified covered calls. The rule is asserted to be unduly harsh, since gain on disposition of a qualified covered call option is taxed as short-term capital gain, whereas loss on disposition of the same option would be treated as long-term loss if the underlying stock has been held for the long-term holding period.[34]

Third, the CBOE proposes to eliminate the holding period suspension rule, except where the underlying stock has

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[33] See CBOE Proposals at 23-26; S. 2086 section 101(a).

[34] See CBOE Proposals at 26-27. In a later submission, the CBOE stated that repeal of the recharacterization rule in tandem with repeal of the holding period suspension rule (discussed in the text at footnote 35, infra) could lead to tax arbitrage opportunities, since gain or loss on short option positions is always short-term under the rule of section 1234(b). As a result, it is instead proposed (i) to deny a current deduction with respect to loss on disposition of a qualified covered call option, and (ii) to add to the tax basis in the underlying stock an amount equal to the loss realized on closing the call position in cases in which a qualified covered call is written on the same day that the underlying stock is purchased. See Addendum at pp. 1-2.

been held at least one day but less than six months and one day.[35] The qualification to the general rule that holding period is not interrupted is said to be necessary since writing an in-the-money covered call during the indicated period could lead to conversion of gain from short-term to long-term.

Fourth, the year-end loss rule of section 1092fc)(4)(E) would be expanded to cover the situation in which the stock (instead of the option) is sold at a loss, the option is closed out at a gain within 30 days, and the gain on the option is recognized in the subsequent taxable year.[36] This same change has been included in the tax reform bill recently adopted by the Senate.[37]

C. Discussion of Proposals

(i) Deep-In-The-Money Call Standard

The question of the point at which a covered call position should be considered deep-in-the-money, thereby implicating the straddle rules of sections 1092 and 263(g), to some extent involves a balance of competing priorities. On the

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35 CBOE Proposals at 28; S. 2086 section 101(c).

36 CBOE Proposals at 32; S. 2086 section 101(b).

37 H.R. 3838 section 422.

one hand, the straddle rules are stringent and sometimes complex; a transaction should not be brought within their ambit unless it offers a material possibility for producing improper tax benefits. On the other hand, it seems clear that relief from the straddle rules should not be provided for transactions involving limited risk that are capable of producing tax deferral and rate conversion.

The specific question here presented is whether an across-the-board 15% in-the-money standard affords the fisc adequate protection against tax straddling opportunities. That judgment in turn depends on the relationship of (x) the degree of economic risk posed by the transaction and (y) potential tax arbitrage benefit3 to be achieved through the transaction. The analysis made by the Congress in rejecting a proposal for use of a 15% in-the-money call standard at the time of adoption of the 1984 Act has been described elsewhere.[38] Inasmuch as these issues present questions involving largely economic considerations, the Committee is not in a position to comment on either the Congressional judgment made in 1984, or the analysis underlying the present proposal. We can, however, make the following observations:

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[38] See wetzler at 459 n.21.

First, as indicated in Exhibit A to this Report, the 15% in-the-money standard would result in exemption from the straddle rules for a large number of options that are significantly deeper-in-the-money than permitted under present rules. Thus, in the absence of counterbalancing factors, it appears that the Proposals would have the effect of permitting significantly greater tax arbitrage opportunities than present law. The Committee is not aware of factors that might mitigate such enlarged opportunities for tax straddle abuses. On the contrary, the Proposals would, for example, repeal the recharacterization rule of section 1092(f)(l). As a result, if a stock position that had been held for the long-term capital gain holding period had significant unrealized appreciation, call could be written that is 15% in-the-money, and greater downside risk protection obtained than would be available under present law. Thus, it appears that the opportunity to obtain offsetting short-term loss and long-term gain -- and thereby convert unrelated short-term gain to long-term -- would be materially enhanced through the combined effect of these Proposals.[39] Tax-motivated trading thus would be encouraged.

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[39] To illustrate, if a taxpayer held appreciated stock currently trading at $100, he might write a call with a strike price of $95, and collect a premium of 5 1/8. Assume the stock increased in value to $103, and the taxpayer sold the stock and closed out the call. The increase in stock price would produce a $3 long-term gain on the stock. It will cost the taxpayer about 8 1/8 to buy in an offsetting option, with the result that the option position will be closed at a loss of $3. The option loss is short-term under section 1234(b). The single market movement thus produces offsetting short-term loss and long-term gain.

(Footnote continued on next page)

Going further, it might be appropriate to consider applying other tax straddle restrictions -- such as section 263(g) -- if, as it appears, taxpayers will be able to more closely approximate a true tax straddle through writing the more deep-in-the-money calls permitted by the Proposals.

Second, as regards the assertion that the present law definition of a deep-in-the-money call is overly complex, we attach as Exhibit B a chart prepared by one of the stock exchanges for use in applying these rules. By reference to this six-line chart, the status of a call as deep-in-the-money may be ascertained. While the present law definition is acknowledged to be somewhat more complex than the 15% standard proposed, it appears to the Committee that the complexity of the present rules is not nearly so great as to justify the increased arbitrage opportunities apparently permitted under the Proposals.

(Footnote continued from preceding page)

The short-term loss may offset other short-term gains of the taxpayer that would be taxed at a 50% rate, thereby producing a tax benefit of $1.50. At the same time, the $3 additional long-term gain would be taxed at a 20% rate, for a cost of $0.60. Thus, a $0.90 tax arbitrage benefit results.

Finally, the Committee recognizes that some distortion to the pattern of options intended to be considered as not deep-in-the-money apparently has resulted from the recent change in the options exchanges' practice of fixing bench marks for stocks trading between $100 and $200.[40] The Committee is not able to gauge the extent to which this change has impinged on taxpayers' opportunity to engage in bona fide economic transactions without unnecessarily implicating the tax straddle rules. Obviously, however, the change has reduced the number of non-deep-in-the-money options that may be written on stocks trading between $100 and $200. The Committee therefore suggests that the Internal Revenue Service and the Treasury consider whether minor changes to the statutory pattern are appropriate in this area to maintain the balance struck in 1984 between exemption from the straddle rules for non-abusive

[40] It is noted that the introduction of more frequent bench marks in the case of stocks priced under $25 had the effect of automatically increasing the number of qualified covered calls that may be written in the case of lower priced stocks. For example, in the case of a stock trading at $14, no call could be written that was not deep-in-the-money under prior exchange practices because the $10 option violated the 85% limitation of section 1092(c)(4)(D)(iii). Under present practice, a $12.50 option could be written without running afoul of the 85% limitation.

transactions and the need to protect the fisc. In light of the authority of the Service to promulgate rules modifying the statutory pattern under section 1092(c)(4)(H) to reflect such changes in the exchanges' practices, it seems clear that this issue can be dealt with without legislation.

(ii) Recharacterization rule

The CBOE contends that the recharacterization rule produces a harsh result because it treats loss on disposition of a qualified covered call option as long-term capital loss where the underlying stock has been held for the long-term holding period, while gain on disposition or lapse of the same option would give rise to short-term capital gain.

In the Committee's view, the current statute produces the correct result. Section 1233(d) has long recharacterized as long-term, losses from "short" positions where gain on an "offsetting" stock position would be long-term. The point in such a case is that the loss suffered with respect to the short position is not "real", in that it is counterbalanced (although not necessarily 100% counterbalanced) by a gain in the stock. Under that circumstance, there is an obvious tax arbitrage opportunity in allowing the taxpayer to claim a short-term loss that is offset by long-term gain, the effect of which could be to convert unrelated short-term gain into long-term gain.

As to the failure of the tax rules to operate in the converse situation, where a short-term gain arises on closing the option position, even though loss on the stock would be long-term, the answer seems to be that the rules of section 1233(d) and their progeny have never done more than protect the fisc, and this taxpayer-adverse result is a potential result that investors have recognized.

(iii) Holding period suspension rule

The CBOE makes a two-part proposal as to the holding period rule of present section 1092(f)(2), First, suspension of the stock holding period is viewed as appropriate for cases where a qualified covered call is written at least one day after the underlying stock is acquired, but prior to the time that the stock has been held for the long-term holding period. The proposal proceeds from the assumption that protection against risk of loss with respect to the stock derives from writing an in-the-money option, even though the option is not deep-in-the-money. As a result, a holding period might be "aged" artificially through writing a qualified covered call if the holding period of the stock were not suspended in this circumstance. Thus, the Proposal would retain the rule of present law where a qualified covered call is written other than on the day the stock is acquired, but before the stock has been held for the long-term holding period.

Second, the CBOE proposes a “married call” rule for cases in which a qualified covered call is written on the same day that the underlying stock is acquired. The desirability of adopting such a rule is discussed below in part 3 of this section.

(iv) Year-end loss rule

The CBOE Proposals, as well as H.R. 3838 as adopted by the Senate, expand the year-end loss deferral rule to cover the situation where (x) the stock underlying a qualified covered call is disposed of at a loss, (y) the call is closed out (or, presumably, lapses) without being held for at least 30 days after termination of the stock position, and (z) the option gain is recognized in a subsequent tax year. The effect of the amendment is to expand the application of the year-end loss rule to the case where, in a declining (or static) market, the taxpayer realizes a loss on the stock and gain on the option, the converse of the situation presently covered by the statute.

In general, the Committee does not oppose this expansion of the year-end loss rule of section 1092(c)(4)(E). As a matter of tax policy, however, it would seem that the stock loss should be disallowed only if it is first determined that the stock position was “straddled” or protected against loss by

the short option position.[41] In the absence of such protection, loss on the stock is unhedged, and, therefore, represents a true economic loss. As an initial matter, it is not clear that the taxpayer obtains a "substantial diminution" of the risk of loss of holding stock by virtue of having written anon-deep-in-the-money call option against the stock.[42] Nonetheless, the current statute apparently embodies a legislative finding that such risk reduction is present.[43] Moreover, the statute effectively self-corrects this problem by disallowing the loss deduction only to the extent of the unrecognized gain in the offsetting option.[44] As a result, to the extent that a loss is unhedged, it may be claimed. Given the history in section 1092(f)(2), and the built-in adjustment mechanism of section 1092(a), the Committee does not oppose the proposed expansion of the scope of section 1092(c)(4)(E).

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41 In the reciprocal case presently covered by the statute, it is perfectly clear that the short option is fully protected against loss by the stock position, so that loss on the option is not "real" in that it is offset by a gain in, the stock. The correctness of applying the loss deferral rule in that context is apparent.

42 See section 1092(c)(2)(A).

43 Section 1092(f)(2) (suspending holding period of stock where qualified covered call written).

44 Section 1092(a)(l)(A).

2. Expansion of 60/40 and Mark to Market Treatment for “Pure” Equity Options

A. Present Law

In 1981, a totally new regime of taxation was developed for application to commodity futures contracts that are traded on a qualified domestic board of trade or exchange, or other board of trade or exchange approved by the Secretary of the Treasury. That regime provides for:

-- Treating such contracts as sold on the last day of the taxpayer's taxable year (“marking to market”), with gain or loss being taken into account at that time.

-- All gain and loss on such contracts being treated as 60% long-term capital gain or loss and 40% short-term capital gain or loss (“60/40 treatment”) regardless of actual holding period, and regardless of whether the contrai5 is a long position or short position.[45]

Since 1981, the number of instruments qualifying for 60/40 treatment and marking to market has expanded significantly. In the Technical Corrections Act of 1982, 60/40 and mark-to-market treatment was made applicable to “foreign currency contracts” on the premise that they

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[45] See Code section 1256 (applicable to "regulated futures Contracts”), added by ERTA sections 501 et seg. Previously, long-term capital gain was available only if the futures contract had been held for more than 6 months, and long-term capital gain could never be achieved on short futures contract positions.

were competitive with regulated futures contracts in foreign currencies.[46]

By 1984, certain stock index futures contracts were trading on domestic commodity exchanges and thus receiving 60/40 and mark-to-market treatment. Given that such futures contracts were competitive with stock index options, Congress believed that 60/40 and mark-to-market treatment should be provided for the latter.[47] Competitive disadvantages also were observed as to options on futures contracts (competitive with futures contracts themselves), options on “physicals” (competitive with futures positions in physicals) and options traded by options “dealers” (who were competitive with persons who traded futures contracts).[48] Accordingly, the 1984 Act extended 60/40 and mark-to-market treatment to:

-- All listed options that were not "equity options". Options thus brought within section 1256 were options on property other than stock, (i.e., options on debt instruments), and options on broad-based stock indices (but not narrow-based stock indices).46

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[46] P.L. 97-448, adding Code section 1256(g), 1256(b) (flush language). H.R. Rep. No. 794, 97th Cong., 2d Sess. 23(1982).

[47] 1984 Bluebook at 306-07.

[48] Id.

-- All listed options granted or purchased by options dealers as part of t business of dealing in options.[49]

Under present rules, the only listed options that fail to qualify for 60/40 and mark-to-market treatment are options on single stocks and narrow-based equity options (“equity options”) that are held or written by investors.

Present law provides that options held by investors (i.e., “long" option positions) produce long-term or short-term capital gain or loss, depending on the holding period for the option.[50] This treatment applies whether the option is sold (in a “closing sale” transaction) or lapses.[51] If the taxpayer is the grantor of an option (i.e., “short” option position), gain or loss from any closing sale transaction, or gain on lapse of the option, is short-term, irrespective of the period of time that the option is outstanding, provided that the taxpayer is not a dealer in such options.[52] In general, option transactions of investors are subject to the loss deferral

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[49] See1984 Act section 102(a)(i); section 1256 (passim). As a result of the 1984 Act amendments, instruments that receive 60/40 and mark-to-market treatment are referred to in the Code as “section 1256 contracts”.

[50] Section 1234(a).

[51] Id.

[52] Section 1234(b).

rules of section 1092(a), and other tax straddle rules, although, as discussed previously, an exception is provided for covered call transactions involving non-deep-in-the-money call opt ions.

B CBOE Proposals

The CBOE Proposals generally would extend 60/40 and mark-to-market treatment to equity options held and written by investors.[53] This change is premised on (i) the view that 60/40 treatment for non-equity options such as broad-based stock options and other section 1256 contracts has resulted in a competitive imbalance in favor of such instruments,[54] and

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[53] CBOE Proposals at 43-44; S. 2086 section 102(a).

[54] The CBOE Proposal states:

> "Thus, derivative products subject to the rules of section 1256 enjoy a competitive advantage over products such as equity options that are subject to other rules. This disparate tax treatment encourages investors to invest in derivative products other than equity options even though there may be no economic reason to make that choice."

and,

> "No tax or economic principle supports the disparate tax treatment of [equity options and section 1256 contracts], and this disparate tax treatment significantly harms the competitive position of equity options in the market place. Accordingly, the definition of a section 1256 contract should be amended to include pure equity options."

CBOE Proposals at 36-37

(ii) a belief that such treatment will simplify the rules regarding taxation of such instruments.[55]

The Proposals would not extend 60/40 and mark-to market treatment to equity options in circumstances in which the option is part of a mixed straddle, including cases in which a stock position is offset by a qualified covered call.[56] This exclusion of equity options from section 1256 contract treatment in situations where a mixed straddle would arise is based on a desire to avoid mixed straddles subject to the mixed straddle rules, as well as a desire to avoid mark-to-market taxation of gains (but not losses) on the section 1256 contract leg of the straddle.[57]

Finally, the Proposals would repeal section 1256(f)(4), which provides that limited partners and limited entrepreneurs may not receive 60/40 treatment with respect to transactions in dealer equity options unless such persons participate actively in management of the dealer entity. The proposal is justified on the premise that if 60/40 treatment is made available to equity options of investors generally, 60/40

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[55] CBOE Proposals at 35-43.

[56] CBOE Proposals at 44; S. 2086 section 102(b).

[57] CBOE Proposals at 42-43.

treatment of dealer options also should be available to persons who are investors in entities that are option dealers.[58]

C. Discussion of Proposals

H.R. 3838, as adopted by the Senate, would provide short-term capital gain and loss treatment for all section 1256 contracts entered into after December 31, 1986.[59] Obviously, this amendment would significantly change the tax treatment of section 1256 contracts.

This Committee does not believe that it is qualified to comment on the proper tax rate to be accorded transactions in particular instruments based on the competitive environment in which those instruments trade. Accordingly, the Committee expresses no view as to the appropriateness of providing section 1256 contract treatment for equity options based on concerns that the tax regime applicable to certain classes of

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[58] See Addendum at 5-6. As noted, the Proposals would not provide 60/40 treatment for equity options held by investors as part of a mixed straddle. The Proposals do not indicate the treatment intended for investors in dealer entities where the entity enters into mixed straddle transactions.

[59] H.R. 3838 section 421. Although the bill would repeal long-term capital gain and loss treatment generally only in the case of individuals (H.R. 3838 section 401), short-term capital gain and loss treatment would be provided for all taxpayers as to transactions in section 1256 contracts.

instruments results in competitive imbalance between equity options and those instruments.

The CBOE's second justification for the proposal to treat equity options as section 1256 contracts rests on the view that the section 1256 regime is far simpler than the alternative section 1092 regime. Obviously, simpler tax treatment of these transactions benefits both taxpayers and government.

As an initial matter, the Committee believes that if a larger number of mixed straddle transactions were to result from expanding the scope of section 1256, simplification would not be achieved. Clearly, the mixed straddle rules[60] are necessary to deal with the difficult problems posed by the interface of 60/40 blended tax treatment for section 1256 contracts and the standard treatment provided for other capital assets. Nonetheless, the mixed straddle rules are by far the most significant source of complexity in the straddle area. The CBOE Proposals attempt to avoid this issue by having a section 1256(d) "mixed straddle" election apply in any case in which an equity option would become part of a mixed straddle. Unfortunately, this solution may raise more questions than it answers.

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[60] Treas. reg. section 1.1092(b)-3T and -4T.

If the automatic mixed straddle election proposed by the CBOE were adopted, as an initial matter, it would be necessary to make clear that where an equity option is held prior to the time that it becomes part of a mixed straddle, gain or loss on the option must be recognized at the time the mixed straddle is established.[61] Failure to provide such a rule would lead to an improper opportunity to defer gains and obtain tax arbitrage benefits. This need to calculate interim gain and loss could well be a source of confusion for ordinary investors.

More fundamentally, the automatic mixed straddle election out rule proposed by the CBOE would result in differing treatment for (x) mixed straddles that include instruments now treated as section 1256 contracts, and (y) mixed straddles that include equity options. Thus, it presumably will be necessary to provide further rules that mesh the two mixed straddle regimes. For example, assume that a straddle is established composed of stocks and broad based equity options, and that an identified mixed straddle election is made with respect to the straddle.[62] Thereafter, assume the straddle is enlarged by acquiring an equity option. Although the proposal

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[61] See Treas. reg. section 1.1092(b)-3T(b)(6) and id., Example 2 for an analogous rule.

[62] Section 1092(b)(2)(A)(i)(I); Treas. reg. section 1.1092(b)-3T.

directs that a section 1256(d) mixed straddle election be deemed to have been made at that time, such an election would not be timely as to the section 1256 contracts already held.[63] Presumably, regulations would provide that the existing straddle positions would be deemed terminated and reestablished when the equity option is acquired, with the section 1256(d) election out there after being applicable to the deemed re-established section 1256 contracts.[64] Thus, a slight difference in the composition of a mixed straddle could result in significant differences in the tax treatment of the straddle.

The obvious question posed by the approach recommended by the CBOE is whether the existence of two independent regimes for mixed straddles, depending on the type of section 1256 contract involved, is not itself a concept that breeds undue complexity. The broader question, however, is whether two approaches are necessary. It is the Committee's view that a single means of rationalizing the treatment of straddles including section 1256 contracts and non-section 1256 contracts

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[63] A section 1256(d) mixed straddle election must be made prior to the close of the first day on which the first section 1256 contract forming part of the straddle is acquired. Section 1256(d)(4)(B).

[64] See Treas. reg. sections 1.1092(b)-3T(b)(5), (6).

should be possible. If the comprehensive election out rule suggested by the CBOE represents the correct rule for pure equity options, it is difficult to see why it represents an improper rule for other section 1256 contracts.

3. Married Put Issues

A. Present Law

Regulation section 1.1092(b)-2T(a)(l) provides that:

> "Except as otherwise provided in this section, the holding period of any-position that is part of a straddle shall not begin earlier than the date the taxpayer no longer holds directly or indirectly (through a related person or flowthrough entity) an offsetting position with respect to that position."

Regulation section 1.1092(b)-2T(a)(2) provides that the foregoing general rule does not apply to a position held by the taxpayer for the long-term capital gain holding period (or longer) before a straddle that includes that position is established. The effect of regulation section 1.1092(b)-2T(a) is that gain realized on the disposition of positions that are part of a straddle (other than (i) positions that qualify for the exception contained in regulation section 1.1092(b)-2T(a)(2) and (ii) section 1256 contracts that generate 60/40 gain) will be treated as short-term capital gain.

Regulation section 1.1092(b)-2T(a) was promulgated under authority of section 1092(b)(l). Section 1092(b)(l) provides in pertinent part that

> "The Secretary shall prescribe such regulations with respect to gain and loss on positions which are part of a straddle as may be appropriate to carry out the purposes of [section 1092] and section 263(g). To the extent consistent with such purposes, such regulations shall include rules applying the principles of . . . subsections (b) and (d) of section 1233."

Section 1233(b) provides that "if gain or loss from a short sale is considered as gain or loss from the sale or exchange of a capital asset under [section 1233(a)] and if on the date of such short sale substantially identical property has been held by the taxpayer for not more than 6 months . . . or if substantially identical property is acquired by the taxpayer after such short sale and on or before the date of the closing thereof", then (i) gain on the closing of the short sale will be treated as short-term capital gain and (ii) the holding period of the substantially identical property will not begin until the date of the closing of the short sale. For purposes of section 1233(b), the aquisition of a put is considered to be a short sale and the exercise or failure to exercise a put is considered to be a closing of a short sale.

The application of the recharacterization and holding period termination rules of section 1233(b) is limited by the so-called “married put” rule of section 1233(c). Section 1233(c) provides that:

> “[section l233(b)] shall not include an option to sell property at a fixed price acquired on the same day on which the property identified as intended to be used in exercising such option is acquired and which, if exercised, is exercised through the sale of the property so identified.”

Under section 1233(c), the acquisition of a “married put” thus does not trigger the application of section 1233(b) to the underlying long position to which the put is “married”. Accordingly, prior to the promulgation of regulation section 1.1092(b)-2T(a), that underlying long position would accrue a holding period in the normal manner.

Regulation section 1.1092(b)-2T(a) eliminates the married put rule of section 1233(c) in the case of transactions meeting the definitional requirement of a straddle. In particular, any pair of positions otherwise qualifying under section 1233(c) (that is, a put option and an underlying long position identified as intended to be used in exercising that option) will constitute a straddle so long as the underlying long position is “actively traded” within the meaning of section 1092(d)(l). Under regulation section

1.1092(b)-2T(a)(l), the holding period of the positions comprising such a straddle will not begin until the straddle is terminated. Regulation section 1.1092(b)-2T(a) contains no exception for straddles comprised of an underlying long position and a put or other position married to that long position.

B. CBOE Proposals

The CBOE Proposals would provide a "married put" exception -- similar to section 1233(c) -- to regulation section l.l092(b)-2T(a)(1).[65] The married put concept also would be extended to "married calls".[66] In general, these rules would require that each the following conditions satisfied:

(i) The put (or call) must be entered into on the same day that the underlying stock is acquired. (Married call treatment also would be provided for "replacement calls".)

(ii) The positions must be identified by the end of the day on which the positions are entered into.[67]

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65 CBOE Proposals at 52; S. 2086 section 103.

66 Id.

67 Technically, Treas. reg. section 1.1233-l(c)(3) permits a 15 day identification rule, and, by implication, the CBOE Proposals would adopt that less stringent standard in the case of a married put. Given, however, that the CBOE proposes a same-day identification rule in the married call setting, it seems probable that a same-day rule also was intended in the case of a married put.

(iii) The underlying stock may not be disposed of, or property other than the underlying stock used to exercise the option, before the long-term capital gain holding period has run. If the underlying stock is disposed of or the option exercised using different property before the long-term holding period has run, the rule of regulation section 1.1092(b)-2T(a)(l) would terminate holding period as to the positions retained.

(iv) If a put lapses, the tax basis of the put would be added to that of the underlying stock (and no loss on lapse of the put would be permitted). If a short call lapsed, short-term gain would be recognized in the amount of the option premium.

(v) If the option position were terminated through a closing transaction resulting in a loss on the option, no current loss would be recognized, and the tax basis of the underlying stock would be increased by the amount of the net loss on the option. If a gain resulted on closing the option, the gain would be taxed currently as short-term gain. In the case of a put, such gain would be long-term if the married positions had been held for the long-term holding period.

If each of the conditions in (i)-(iii), above, is satisfied, the holding period of the underlying stock and a long put would begin on the day the positions are entered into. However, if the stock had been held at least one day when the offsetting position is entered into, the holding period termination rule of regulation section 1.1092(b)-2T(a)(l) would In addition, the underlying stock had been held for

the long-term capital gain holding period at the time the offsetting position is entered into, entry into an offsetting position would not eliminate holding period, as provided currently in regulation section 1.1092(b)-2T(a)(2).

The "married put" and "married call" rules outlined above also would be extended to "married straddles".[68]

C. Discussion of Proposals

The Committee believes that there is substantial merit to the proposal to provide an exception to the rule of regulation section 1.1092(b)-2T(a) for married puts, married calls, and married straddles. The Committee believes that these transactions are not "abusive", and do not offer an opportunity to obtain improper tax benefits through the conversion of short-term capital gain to long-term capital gain, or otherwise. Just as married put transactions were excluded from the short sale rules of section 1233(b) that were the forerunner of the tax straddle rules, the Committee believes that married put and similar transactions should be excluded from the straddle rules as well.[69]

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[68] CBOE Proposal at 52-55; S. 2086 section 103.

[69] The Committee previously considered the absence of a married put concept from regulation section 1.1092(b)-2T(a) in its Report on the Proposed and Temporary Regulations under Section 1092, dated January 6, 1986, pp. 56-62. In that Report the Committee stated that "[it] has been unable to devise a substantive rule that is clearly preferable to the approach taken in the regulations and accordingly, it makes no recommendation on this issue". Id. at 61. Although other factors were adverted to, the concern expressed by the

The Committee believes that regulation section 1.1092(b)-2T(a) should prevent any use of straddles to convert short-term capital gain to long-term capital gain, including any use of straddles to "lock in" the gain on, and to age the holding period of, positions on which unrealized short-term gain exists at the time that the straddle is established. The Committee further believes that a straddle affords no opportunity for conversion of short-term capital gain to long-term capital gain if all of the positions of the straddle are entered into simultaneously and if certain other requirements are met.

(i) History of Sections 1233(b) and 1233(c)

Section 1233(b) was enacted to eliminate the use of short sales and puts to convert unrealized short-term capital gain to long-term capital gain. Prior to the enactment of section 1233(b), a taxpayer could use short sales and puts to lock in unrealized short-term gain on a position held by the taxpayer; the gain position would then be held without risk of depreciation in value for the remainder of the long-term holding period, thus

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Committee with respect to a married put exception related largely to the possibility that the taxpayer could acquire "other positions identical to one or more components of the married put and, thus, . . . possibly affect the characterization of gain by the choice of whether to sell the put separately or exercise the put component of the married put with the security to which it is married or with another security". Id. at 60-61. If the Committee's recommendation is accepted that "married put"-type treatment be provided only if a larger straddle is not present (see footnote 78, infra), the Committee believes that the proposals made by the CBOE respond to concerns expressed in the prior report regarding the use of married puts, etc. to obtain improper tax advantages.

“aging” the holding period of the gain position and converting the unrealized short-term gain to long-term gain.

This conversion abuse may be illustrated by the following example. Assume that a taxpayer purchased 100 shares of stock on January 1 at a price of $100 per share and that, on May 1, the value of that stock had appreciated to $140 per share. The taxpayer could then purchase, for a premium of $20.50, a put with a strike price of $160 per share expiring on August 1. If the price of the taxpayer's stock remained below $160 per share on July 2, then the taxpayer could exercise the put and sell the stock at a price of $160 per share, realizing a long-term capital gain of $39.50 per share. In effect, by purchasing the put option on May 1, the taxpayer locks in $39.50 of unrealized short-term gain on the underlying stock position without selling that stock position, thus effectively eliminating market risk with respect to the unrealized gain for one month of the six-month long-term holding period.[70]

Section 1233(b) was designed to eliminate this conversion abuse by eliminating the holding period of the stock position. Indeed, it is apparent from the legislative history of section 1233(b) that section 1233(b) was exclusively intended to prevent this use of short sales and puts to convert short-term capital gain

[70] If the price of the taxpayer's stock exceeded $160 per share on July 2, the taxpayer could sell the stock at the market price, realizing long-term capital gain, and allow the put to lapse, realizing short-term capital loss.

to long-term capital gain and that section 1233(b) was not intended to apply to situations where no such conversion possibility was present.

The predecessor to section 1233(b) was originally enacted as a part of the Revenue Act of 1950. The House Ways and Means Committee Report with respect to that Act began its discussion of the proposed section by describing the conversion abuse then available to investors:

> "At the present time it is possible for an investor in stocks to realize a capital gain in less than 6 months and obtain long-term capital gain tax treatment on [the gain] by making a short sale which will assure his gain on his original investment, and then defer closing out the short sale until he has held his original stock investment for more than 6 months."[71]

The Committee Report then gave three examples of the operation of the "short-sale device". In each such example, the taxpayer first purchased a long position and then locked in short-term appreciation on that long position by entering into a short position.[72]

The Committee Report described the inclusion of puts within the definition of a short sale for purposes

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[71] H.R. Rep. No. 2319, 81st Cong., 2d Sess. (1950), reprinted at, 1950-2 C.B. 380, 421.

[72] H.R. Rep. No. 2319, supra, 1950-2 C.B. at 421-22. Two of the three examples involved a long physical position and a short sale while the third example involved long and short futures contracts. A fourth example, given later in the Committee Report, changed the order of purchase of the positions by the taxpayer, with the taxpayer first entering into a short sale of stock and then locking in a gain by purchasing a long physical position. See H.R. Rep. No. 2319, supra, 1950-2 C.B. at 448.

of the proposed provision by referring to the ability of a taxpayer to use a put to lock in pre-existing appreciation on a long position:

> "[A] person who buys a 'put' is assured that he will realize the appreciation in value of his stock just as though he had made a short sale. For this reason a short sale is defined as including a put. . . ."[73]

Finally, the Committee Report specified that the rules of the proposed section would not apply to arbitrage transactions in commodities futures contracts where a taxpayer entered into long and short contracts on the same day and closed out those contracts on the same day.[74] In effect, an exemption was provided from section 1233(b) for a type of transaction that, by virtue of the simultaneous purchase and disposition of the component positions in the straddle, presented no opportunity for the taxpayer to convert short-term capital gain to long-term capital gain.[75]

The enactment of section 1233(c) in 1954, and the legislative history of that section, provide further support for the proposition that section 1233(b) was intended to prevent the use of short sales and puts to convert short-term capital gain to long-term capital gain and that section 1233(b) was not intended to apply to

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[73] H.R. Rep. No. 2319, supra, 1950-2 C.B. at 422.

[74] Id. See section 1233 (e)(3).

[75] The Senate Finance Committee Report contains a discussion of the predecessor to section 1233(b) that is substantially similar to the discussion contained in the House Ways and Means Committee Report. See S. Rep. NO. 2375, 81st Cong., 2d Sess. (1950), reprinted in, 1950-2 C.B. 483, 515-16, 544-46.

situations where no possibility of such a conversion abuse was present. The Senate Finance Committee Report on the Internal Revenue Code of 1954 explained the reasoning underlying the enactment of section 1233(c), in pertinent part, as follows:

> "[P]resent law provides a presumption that a 'put' (an option to sell an asset at a fixed price) is a short sale. This prevents the use of a 'put' to artificially extend a speculative commitment beyond 6 months. However, if a 'put' is purchased with the stock which is to be issued to exercise it in order to hedge against a decline in its value, the taxpayer is denied long-term capital gain[] treatment. To avoid this result a 'put' is not to be presumed a short sale if, among other things it is purchased at the same time as stock to be used to fulfill the contract."[76]

Section 1233(c) excepts from the application of section 1233(b) a set of positions comprised of a put and an underlying long position identified as intended to be used in exercising that put if (i) the positions are acquired on the same day, (ii) the put, if exercised, is exercised through sale of the underlying long position, and (iii) the positions are timely identified on the taxpayer's books. It is apparent that the rule of 1233(c) was based on a Congressional recognition that a straddle comprised of a married put and an underlying long position could not operate "to artificially extend a speculative commitment beyond 6 months" -- that is, that such a straddle could not be used to lock in unrealized short-term capital gain and thereby to convert that short-term capital gain to long-term capital gain.

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[76] S. Rep. No. 1622, 83d Cong., 2d Sess. (1954), reprinted in, 1954 U.S. Code, Cong. & Admin. News 4621, 4746-47. The House Ways and Means Committee Report on the Internal Revenue Code of 1954 contains substantially similar language. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 83 (1954).

(ii) Proper Scope of Regulation Section 1.1092(b)-2T(a)

Given the purpose of section 1233(b) to prevent the conversion of short-term capital gain to long-term capital gain, what is the appropriate scope of regulation section 1.1092(b)-2T(a)? The Committee believes that regulation section 1.1092(b)-2T(a), like section 1233(b), should be designed to prevent the conversion of short-term capital gain to long-term capital gain.[77] In order so

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[77] The legislative history of section 1092(b) strongly supports the view that the only purpose of applying the principles of section 1233(b)(1) was to prevent "aging" of a holding period of an asset in which there was unrealized gain. The Senate Committee Report accompanying the enactment of section 1092 in ERTA explained the need for rules similar to section 1233(b) as follows:

> Under section 1233(b), . . . the holding period of property held by the taxpayer which is substantially identical to the property sold short and not used to close the short sale, does not commence until the short position is closed (unless the long-term holding period requirement was already satisfied for such property when the short position was created). However, the holding periods of properties not satisfying the substantially identical standard of section 1233 are unaffected by its holding period rule, even if they are offsetting positions subject to the loss deferral rule of new section 1092. Section 1233(b) does not affect, for example, the typical tax-shelter commodity straddle because futures contracts calling for delivery in different calendar months are defined as not substantially identical (sec. l233(e)(2)(B)). As a result, a short-term gain can be converted into a long-term gain by creating a straddle if the "long leg" increases in value and by holding the straddle for enough time to satisfy the long-term holding period requirement.

S. Rep. No. 144, 97th Cong., 1st Sess. 149 (1981) (emphasis added).

As is evident from the quoted language, the purpose of regulations under section 1092(b) applying the principles of section 1233(b) was to substitute "the concept of offsetting positions . . . for the . . . concept of substantially identical property". Id. Such a change would close the loophole in section 1233(b) that enabled taxpayers to obtain

to prevent conversion, regulation section 1.1092(b)-2T(a) must address two situations -- (i) the use of straddles to lock in unrealized short-term gain existing at the time that the straddle is established, thus effecting the conversion abuse that section 1233(b) was enacted to prevent, and (ii) the use of straddles to generate offsetting amounts of long-term capital gain and short-term capital loss, thus effecting a conversion of unrelated short-term capital gain to long-term capital gain through a tax arbitrage. The Committee believes that the married put, married call and married straddle proposals (hereinafter referred to collectively as the "married straddle" proposals) meet these objectives.[78]

A married straddle rule constructed in the manner proposed offers no opportunities for conversion of short-term capital gain to long-term capital gain. Stated conversely, a straddle presents opportunities for conversion if (i) the straddle locks in preexisting unrealized short-term capital gain on one of the constituent positions of the straddle or (ii) the straddle includes one or more positions that could generate short-term capital loss on disposition while other positions of the straddle accrue holding period

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long-term capital gain treatment of short-term capital gain by locking in existing gain on property with an offsetting position that was not substantially identical to the gain property (just as, prior to enactment of section 1233(b), taxpayers could lock in gain by selling property short).

[78] A crucial assumption to the functioning of these rules is that all of the positions that comprise the straddle satisfy the conditions set forth previously. Thus, the Committee recommends that married straddle treatment be provided only if the married straddle is not part of a larger straddle. See section 1092(a)(2)(B)(iii) (imposing the same requirement in the case of "identified straddle" elections).

such that, after a brief interval, long-term gain might be realized.[79] In general, a straddle subject to the married straddle rule proposed cannot lock in unrealized short-term capital gain because all of the positions of the straddle must be entered into on the same day. Equally, such a straddle includes no positions that can generate short-term capital loss on disposition in conjunction with a position that can generate long-term gain because, with the exceptions discussed below, the disposition of any position prior to elapse of the long-term holding period retroactively terminates the marriage. Finally, no case qualifying for exception to these rules results in more favorable tax treatment:

(i) If a put held by the taxpayer expires unexercised, the basis of the put is added to the basis of the underlying stock. As a result of the basis adjustment, loss with respect to the put necessarily will have the same “character” (long-term as short-term) as the underlying stock, and no conversion of short-term gain to long-term gain can occur.

(ii) If a call written by the taxpayer expires unexercised, current short-term gain is recognized. The current recognition of short-term gain obviously is inconsistent with any-tax arbitrage advantage.

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[79] To illustrate the situation addressed in (ii), assume that, on January 1, a taxpayer enters into offsetting long and short forward contracts. Assume further that, by June 30, the long position has appreciated in value and the short position has depreciated in value. In the absence of a contrary rule, the taxpayer could close the short position on June 30, generating short-term capital loss, and close the long position on July 2, generating long-term capital gain. Such a transaction could convert unrelated short-term capital gain to long-term capital gain.

(iii) If a put or call is closed out at a loss, such loss is not recognized, but the amount of the loss is added to the basis of the underlying property or opposing straddle position, with results as in (i).

(iv) Except as provided in (v), if a put or call is closed out at a gain, such gain is taxed currently as short-term capital gain, as in (ii).

(v) If a put is closed out after the long term holding period has run, gain will be treated as long-term capital gain. No tax arbitrage opportunity arises because disposition of the underlying stock position would produce long-term capital loss.

(iii) Policy Issues Relating to Risk Reduction

In the absence of any conversion abuse, the question arises whether it is possible to justify the application of the holding period termination rule to a married straddle on the ground that the holding period of a position should be terminated simply because the risk of holding the position is substantially diminished. The Committee believes that such an argument is unsound.

Under the married straddle rule proposed, all positions of the married straddle will generate gain or loss of the same character -- long-term or short-term (unless less favorable tax treatment results from early termination of one or more positions). The aggregate net gain or loss on these positions will be an economic gain or loss that reflects and arises from the net market risk taken by the taxpayer in holding the straddle as a whole. In effect, the straddle is properly viewed as the equivalent of a single position in terms of aggregate net gain or loss realized and aggregate net market risk

assumed.[80] The Committee believes that as a matter of tax policy, it is not appropriate to deny long-term capital gain (or loss) treatment to a taxpayer with respect to the aggregate net economic gain or loss resulting from such a straddle, all of the positions of which have been held for the long-term holding period.

* * *

The foregoing discussion is based on the assumption that none of the married straddle positions qualifies for 60/40 treatment. In the case of mixed straddles, some positions are entitled to partial long-term capital gain treatment without regard to actual holding period. The possibility for tax arbitrage in such cases goes beyond the scope of the protections required where long-term capital gain treatment arises only following accrual of a holding period. Accordingly, while the issue is not considered in the CBOE Proposals, the Committee recommends that married straddle relief be provided only in the case of straddles that do not include section 1256 contracts, unless an election has been made to treat such contracts as non-section 1256 contracts under section 1256(d) or otherwise.

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[80] A married put obviously represents a type of hybrid investment, with the taxpayer having accepted equity risks as to one range of stock prices, but only a credit risk as to another range of stock prices. An investment consisting of stock and a put on the stock obviously bears a strong resemblance to a convertible debt obligation. Yet no one would propose to deny a long-term holding period with respect to a convertible debt obligation because the holder has no downside risk with respect to the stock.

4. Special Options Dealer Account

A. Present Law

Dealer equity options (defined below) generally are subject to the mark-to-market rules and 60/40 treatment prescribed by section 1256. Thus, under present law, dealer equity options are taxed at a maximum individual rate of 32 percent.

"Dealer equity options" are stock options (including narrow-based stock index options) that are purchased or granted by an options dealer in the normal course of his activity of dealing in options and are listed on a qualified board or exchange on which the options dealer is registered.[81]

In general, an "options dealer" means any person registered with an appropriate national securities exchange as a market maker or specialist in listed options.[82] Unlike "dealers" generally, options dealers are treated as buying and selling capital assets (rather than ordinary income property).

Taxpayers can elect to assign positions which they find impractical to identify as mixed straddles, because of the volume of their transactions or for other reasons, to a mixed straddle account. Specific straddle-by-straddle identification of offsetting positions is not

[81] Section 1256(g)(4).

[82] Section 1256(g)(8).

required for positions assigned to a mixed straddle account.

Although dealer equity option positions in mixed straddle accounts are accorded 60/40 treatment, transactions in stock or other assets that are not section 1256 contracts generally produce short-term gain or loss. (Options dealers may enter into stock positions to "hedge" their exposure under option positions.) In the case of options dealers that utilize a mixed straddle account, the actual proportion of annual gain or loss that is long-term or short-term will depend on the extent to which such gain or loss arises from dealer equity options, which produce 60/40 gain and loss, or stock or other property, which produce short-term gain and loss. In no event, however, can more than 50 percent of annual net gain from a mixed straddle account be treated as long-term capital gain; in addition, no more than 40 percent of annual net loss may be treated as short-term capital loss.[83] Amounts in excess of these limits are recharacterized as short-term capital gain and long-term capital loss, respectively. As a result of the 50% gain limitation, net gains from a mixed straddle account are taxed at a minimum (marginal) rate of 35% in the case of an individual subject to the maximum rate of tax under present law. Of course, the rate of tax may be higher.

Under Treasury regulations, each position in a mixed straddle account must be marked to market on a daily basis. Net gains or losses from section 1256

[83] Section 1092(b)(2)(B).

contracts and net gains or losses from other positions are combined to determine daily account net gain or loss.[84] At year-end, the daily totals are combined to give "annual account net gain or loss". If several mixed straddle accounts are maintained, the "annual account net gain or loss" for all such accounts is then determined as "total annual account net gain or loss."[85] The 50 percent limit on net long-term gain and the 40-percent limit on net short-term loss applies to this annual total.

B. CBOE Proposals

Options dealers, as defined under present law, would be allowed to elect a special method of accounting for mixed straddles, referred to as an "options dealer account". This method would be an alternative to treating dealers' mixed straddles as identified mixed straddles, or as assigned to a mixed straddle account.[86]

Positions would be marked to market upon being placed into an options dealer account. They would not be required to be placed into an options dealer account on the date of acquisition; instead, such positions would be designated for an "options dealer account" pursuant to an election required to be made "early in the taxable year". Unlike the mixed straddle account, an options dealer account would not be subject to daily marking to market and daily netting; instead, positions would be marked to

[84] Treas. Reg. section 1.1092(b)-4T(c).

[85] Treas. Reg. section 1.1092(b)-4T(c)(2).

[86] CBOE Proposals at 59-60; S. 2086 section 104(a).

market and netted only at year-end. Net gain or loss (after application of section 263(g) capitalization requirements) would be taxed at a maximum individual rate of 37 percent under present law tax rates,[87] notwithstanding the portion of gains in the account that would otherwise be taxed as short-term capital gain.

The proposal would apply to taxable years beginning after 1984.

C. Discussion of Proposals

Proponents view the options dealer account as a necessary, simpler alternative to the present law methods for dealing with mixed straddles. The proposal is designed to conform to present industry record-keeping practices. According to the Proposals, options dealers do not themselves maintain records adequate to separate the gain or loss on the stock from the gain or loss on the stock option positions constituting straddles. The Proposals do not identify specific impediments to the recordkeeping required under current law.

Unlike the mixed straddle account that all taxpayers may elect, the options dealer account would be available only to persons who satisfy the definitional requirement of an “options dealer”. This Report refrains

[87] That is, the rate of tax applied to account gain would not depend on whether the gain arose from dealer equity options, or from stock (or other property) that would otherwise give rise to tax at a 50% rate. The proposed maximum rate would be achieved by treating net gain or loss as 43 percent long-term capital gain or loss and 57 percent short-term capital gain or loss. CBOE Proposals at 59-62; S. 2086 section 104.

makes no comment as to the absolute level of the proposed 37% maximum rate of tax that would be imposed on transactions of an options dealer electing this new account. Today, options dealers enjoy a special preference in that options dealers (but not investors) are accorded 60/40 treatment with respect to their transactions in equity options. Options dealers gain the benefit of this preference only as to their transactions in equity options, however. The proposal therefore enlarges the existing preference to include transactions in any type of property related to the taxpayer's options dealer activities.

In addition, the ability of options dealers to designate some, but not all, positions to the options dealer account could permit selective, and possibly abusive designations of a type forbidden in the case of the elections for other special regimes and account assignments under sections 1256 and 1092. As a result, it seems clear that all offsetting positions should be required to be included in the account.[88] In addition, allowing a time-lag between the date of acquisition of a position and its date of designation to the special account obviously creates a potential for abuse. This selectivity could have a significant revenue impact if the suggested retroactive effective date for the proposal were enacted.

In summary, while the Committee refrains from commenting on the creation of a new, reduced rate of tax

[88] See Treas. Reg. section 1.1092(b)-4T(b)(2), (b)(4)(ii).

for options dealers, the Committee notes that the proposal appears to contain certain technical flaws that could lead to tax abuses.

5. Sections 263(g) and 263(h)

A. Present Law

Section 263(g) requires the capitalization of net interest and carrying charges allocable to positions of a straddle. Net "interest and carrying charges" are defined to mean the excess of prescribed expense items allocable to a straddle over the prescribed income items so allocable.

The expense items taken into account are:

-- Interest on debt allocable to straddle positions.

-- Amounts paid to "carry" straddle positions (e.g., storage and transportation charges).

-- Short sale expenses incurred with respect to short straddle positions.[89]

The income items taken into account are:

-- Interest (including original issue discount) includible in income with respect to -positions of a straddle.

-- Market discount that is treated as interest under section 1278 with respect to straddle positions.

-- The excess of (x) dividends received with respect to stock that is part of a straddle

[89] Section 263(g)(2)(A), and flush language.

over (y) any dividends received deduction with respect to the stock.[90]

Section 263(g) was enacted in ERTA to curb the tax avoidance opportunity presented in situations in which deductible interest and carrying charges in a straddle transaction were economically counterbalanced by capital gain items, with the result that the expenses might be deducted currently against ordinary income, and the gain would be taxed on a deferred basis, possibly at long-term capital gains rates.

The most obvious such transaction is a so-called cash and carry in which the taxpayer would acquire a long physical position, such as silver, offset by a short silver futures contract. Interest, storage charges and other expenses of carrying the physical silver would be deducted currently. Because the future delivery price of silver (and certain other commodities) can usually be expected to reflect such interest and

carrying charges, in the absence of price fluctuation, the physical silver could be expected to be sold in the subsequent tax year to produce long-term gain equal to the interest and carrying charges deducted. In all events, however, the offsetting futures contract would protect against risk of economic loss in the transaction. By capitalizing the interest and carrying charges in the transaction, section 263(g) insures that the character and timing of the expense allowances will be aligned with

[90] Section 263(g)(2)(B).

the character and timing of the offsetting gain on the transaction.

In the case of persons electing a mixed straddle account, Treasury regulations require application of section 263(g) to interest and carrying charges "allocable to [the] account".[91] Amounts so capitalized then adjust the annual account net gain or loss and are allocated pro rata between net long-term gain and loss and net short-term gain or loss.[92]

Section 263(h) addresses a different problem that arises because dividends and "short" dividend expense necessarily are accounted for on the cash method of accounting. To illustrate, assume that prior to adoption of section 263(h), stock of X Co. is trading at $109, and that X Co. has declared a $9 dividend payable to holders of record on a certain date. Immediately prior to the stock exchange "ex-dividend" date for the dividend, Individual A sells the stock short. Under usual practice, A will be required to pay $9 to the lender of the shares used in the short sale in order to indemnify the lender of the shares for loss of the dividend. In addition, X Co. stock can be expected to drop in price by approximately the amount of the dividend immediately after the stock goes ex-dividend.

Thus, continuing the example, the stock drops to approximately $100 at the beginning of the ex-dividend

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[91] Treas. Reg. section 1.1092(b)-4T(c)(3).

[92] Id.

date, and A closes the short sale at that price, producing a $9 profit on the short sale transaction, but no gain or loss overall when the "in lieu" payment is taken into account. An individual may deduct the in lieu payment under section 212.[93]

Thus, the transaction -- which might occur within the space of a few days or less -- would result in A's having a $9 ordinary deduction and a $9 short-term capital gain on closing the short sale, thereby converting unrelated capital losses that otherwise might be non-deductible under section 1211 into deductible ordinary expenses.[94]

Section 263(h) addresses this problem by requiring capitalization of the dividend equivalent expense unless the short sale is held open at least 46 days (1 year in the case of an extraordinary dividend as defined in section 1059(c)).[95] By requiring the taxpayer to accept a measure of market risk as a condition of

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[93] Rev. Rul. 72-521, 1972-2 C.B. 178; Rev. Rul. 62-42, 1962-1 C.B. 133. A corporation may deduct an in lieu payment under section 162 if it is a trader or dealer in securities. E.g., 1955 Production Exposition v. Commissioner, 41 T.C. 85 (1963).

It appears that the present treatment of short sale expenses of individuals effectively would be conformed to the rule for corporations by the Senate .Finance Committee measure generally repealing the deduction for section 212 expenses. H.R. 3838 section 132. A similar result could arise under section 132 of the House bill due to its limitation of the deduction for section 212 expenses to amounts in excess of 1% of the taxpayer's adjusted gross income.

[94] See 1984 Blue Book at 157-58

[95] The holding period is suspended for periods during which the taxpayer reduces his risk of loss with respect to the short position. Section 263(h)(4).

allowing deductibility of the short sale expense, section 263(h) substantially eliminates this opportunity for risk-free tax arbitrage through short sale transactions in stocks.[96]

An exception to the capitalization rule of section 263(h) is provided to the extent that the taxpayer earns compensation for collateral left on deposit to secure the return of the property used in the short sale.[97] Thus, if, in the example, A left the $109 short sale proceeds on deposit with the lending broker, and he received $0.50 as compensation there for, he would be required to capitalize $8.50, rather than $9.00 if he failed to satisfy the 46-day requirement of section 246(h). This relief rule derives from the principle that short sale expenses should be deductible to the extent they represent an expense for the use of the property sold short, rather than an "accrued" dividend, which

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[96] The Treasury Department explained the proposal that ultimately was enacted as section 263(h) as follows:

> "By establishing a relationship between the magnitude of the dividend paid and the period that the short sale is held open, the proposal limits the deductibility of dividend substitute payments to cases in which the payment can be said to represent a charge incurred by the taxpayer for the use of the property sold short. Where a large dividend is paid and the short sale is held open only for a brief period of time, the dividend generally will have matured prior to the time of the short sale. Thus, the dividend right should be treated as a separate asset that has been borrowed and sold, so that capitalization of the dividend substitute payment is appropriate to eliminate any built-in loss."

Department of Treasury, General and Technical Explanation of Revenue Proposals Contained in dministration's Fiscal Year 1985 Budget, February 17, 1984, reprinted in BNA Daily Tax Report, February 21, 1984, at 5-35, 5-83.

[97] Section 263(h)(5).

represents capital in an economic sense.[98] Thus, to the extent the taxpayer earns compensation on the collateral left on deposit, he has demonstrated the approximate portion of the short sale expense that may be considered to represent a current expense that is properly deductible.

In the case of short sale expenses of straddle positions, the requirements of section 263(h) are to be applied prior to section 263(g).[99]

B. CBOE Proposals

First, the CBOE would provide alternate rules for application of section 263(g) to permit options dealers and commodities dealers (both as defined in present law) to elect to apply section 263(g) on a business-wide basis. (It is also proposed that section 263(g) would be modified in several respects, as described below.) As a first step, all section 263(g) income and expense items related to the taxpayer's business activities would be netted. As a second step, capital gains and losses from section 1256 contracts or other property acquired in the ordinary course of the taxpayer's business would be netted under the rules of section 1222. Finally, the results of the two steps would be combined. If the result is a net capital loss (under step 2) and ordinary income (under step 1), the capital

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98 Compare Treas. reg. section 1.61-7(d) which treats as a capital item interest accrued on a bond prior to its acquisition by the taxpayer. Obviously, such an analysis cannot be made of dividends on stock, which do not accrue.

99 Section 263(g)(4)(A).

loss would be deductible against the ordinary income. In other cases, no special rule would be provided.[100]

This opportunity to offset capital losses against ordinary income is said to be necessary because, under certain circumstances, an options dealer may earn substantial ordinary income, and incur substantial capital losses. Although the taxpayer's net income may be small, his taxable income would be significant in the absence of an ability to offset capital losses against ordinary income.[101]

Second, the CBOE proposes several modifications to section 263(g):

-- The category of expenses required to be capitalized under section 263(g)(2)(A) would be broadened to include (i) amounts paid that are "treated by the recipient as payments with respect to securities loans (within the meaning of section 512(a)(5))", and (ii) amounts required to be capitalized under section 263(h) with respect to short stock positions.

-- The category of income items that reduce the capitalization requirement under section 263(g)(2)(B) would be broadened to include (i) amounts received by the taxpayer as compensation for the use of property in a short sale, and (ii) amounts representing payments with respect to securities loans within the meaning of section 512(a)(5).

Third, the CBOE would modify the treatment of short sale expenses required to be capitalized under section 263(h) by treating such items as expenses subject

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[100] CBOE Proposals at 68-69; S.2086 section 105(b).

[101] CBOE Proposals at 66.

to capitalization under section 263(g)(2)(A)(except to the extent offset by income items under section 263(g)(2)(B)).

C. Discussion of Proposals

(i) Special Capitalization Rules for Options and Commodities Dealers

The Code's longstanding prohibition against offsetting capital losses against ordinary income lays the basis for the CBOE proposed amendments to section 263(g). Numerous arbitrage transactions that are fully justifiable economically, and involve no attempt to gain a tax advantage, carry the possibility of producing either ordinary income or capital loss, depending on the movement of the market. Over time, taxpayers that engage regularly in such transactions may be confronted with significant ordinary income offset by non-deductible capital losses.

An overall solution to this problem is not obvious. The CBOE Proposals attempt to deal with the problem by creating the broadest possible base within which to net section 263(g) income and expense. Instead of present law rules requiring such netting within each mixed straddle account -- a separate account must be maintained for each "class of activities"[102] -- the Proposals would allow such netting on a business-wide basis in the case of options and commodities dealers.

[102] In situations in which a mixed straddle account is not utilized, present law requires separate netting as to each straddle transaction.

While it is not possible to devise a solution that will deal adequately with the competing considerations, two things are apparent. First, enlargement of the base for netting section 263(g) income and expenses to all option or commodity dealer business activities is likely to lead to opportunities to convert ordinary income to long-term gain such as through the acquisition of positions for the purpose of producing additional interest or dividend income. Second, the problem is one of much greater scope than options and commodities dealers. It affects virtually all persons engaged in financial arbitrage. Accordingly, in the Committee's view, while the problem identified in the Proposals may be real in some cases, it also must be recognized that the limitations of section 263(g) clearly serve a proper function. In the Committee's judgment, creating an effective partial exemption from these rules for one group of taxpayers would not represent sound tax policy, and may create opportunities for tax abuses.

A related aspect of the CBOE Proposals, allowing offset of capital losses from dealer activities against ordinary income from such activities, raises a fundamental question of tax policy. With limited exceptions, the benefit of long-term capital gain treatment has been coupled with the detriment of strict limits on deductibility of capital losses.[103] If relief

[103] As a matter of tax policy, the limitation on deductibility of capital losses is based most significantly on the concern that taxpayers can selectively realize losses but not gains from their; portfolio, and thereby obtain tax shelter benefits. In a setting in which all related transactions of a taxpayer are

from these basic restrictions were appropriate for options and commodities dealers, it would be equally appropriate for numerous participants in the financial markets, and perhaps others. The Committee opposes such an exception for options and commodities dealers.

(ii) Modifications to Section 263(g) Income and Expense Items

The Proposal to include as an expense item subject to section 263(g)(2)(A) "amounts paid that are treated by the recipient as payments with respect to securities loans (within the meaning of section 512(a)(5))" is, in the Committee's judgment, not necessary in light of the broader coverage of short sale expenses presently provided pursuant to the flush language of section 263(g)(2).[104] Under the proposal, qualification of the securities lending transaction under sections 1058 and 512(a)(B) would be required to trigger application of the proposed rule. It is not clear why failure to satisfy these technical requirements -- perhaps intentionally -- should prevent the proper

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accounted for such that all unrecognized gain and loss are taken into account not later than yearend on a mark-to-market basis, concerns regarding the selective realization of losses clearly are diminished. In all events, however, it would not be proper to allow a greater portion of capital loss to offset ordinary income than the portion of capital gain that is subject to tax at ordinary rates (i.e., 40% under present law)

[104] The flush language states: "[f]or purposes of subparagraph (A), the term 'interest' includes any amount paid or incurred in connection with personal property used in a short sale". Although the proposals would not repeal the flush language of section 263(g)(2), it is not clear why both that language and the proposed amendment are considered necessary.

functioning of section 263(g) as regards short sale expenses.[105]

Next, it is proposed to expand the list of income items described in section 263(g)(2)(B) to amounts received by the taxpayer as compensation for the use of property in a short sale.[106] The issue underlying this change could arise, for example, if a taxpayer were "long" Y Co. stock and "short" Y Co. convertible debentures, such positions forming a straddle. Dividends on Y Co. stock would qualify as income items under section 263(g)(2)(B)(iii). If, however (and perhaps without the taxpayer's knowledge), the X Co. shares were borrowed from the taxpayer by the taxpayer's broker for use by another in a short sale, the taxpayer would not receive a dividend, but instead would receive an "in lieu" of dividend payment, which apparently would not constitute a qualifying income item for purposes of section 263(g).

The Committee believes that it is appropriate to offset the capitalization requirements for such "in lieu" payments received by the taxpayer. As an economic matter, the "lending" taxpayer stands in no different position

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[105] For example, under the proposed section 1058 regulations, a transaction is disqualified if the securities loan does not provide that the lender of the securities may terminate the loan on not more than 5 business days notice. Prop. reg. section 1.1058-l(b). It is not difficult to imagine transactions structured deliberately to fail the foregoing test if the same could defeat the section 263(g) capitalization requirements.

[106] This change also would be made by H.R. 3838 section 1808(b) and section 1508(b) of H.R. 3838 as passed by the House of Representatives.

due to the loan of his securities. However, the Committee does not believe that technical compliance with sections 1058 and 512(a)(5)(B) should be a prerequisite to claiming the benefits of the offset provision. Irrespective of the tax treatment of the underlying transaction for purposes of section 1058, the taxpayer in receipt of an "in lieu" payment has received an income item, and, to that extent, it is not appropriate to deny a deduction for offsetting expenses under section 263(g). Accordingly, the Committee recommends a broader offset for the short sale income items than those contained in the pending bills. The Committee recommends that the rule instead be drafted to parallel the rule contained in the present flush language of section 263(g)(2), i.e., to apply to any amount received in connection with personal property lent for use in a short sale.

(iii) Coordination of sections 263(g) and 263(h)

Presently, short dividend expenses are subject to capitalization under section 263(h) if the short sale is not held open at least 46 days (1 year in certain cases). The CBOE Proposals would remove such expenses from the ambit of section 263(h), and instead would subject the expenses to the capitalization requirements of section 263(g), in situations in which the short stock position is part of a straddle. Thus, the CBOE Proposals would reverse the rule of present section 263(h)(6). The Committee believes that the proposal is not consistent with the purposes of the sections 263(g) and 263(h), and

would significantly limit the effectiveness of section 263(h).

Take, for example, the case where stock is sold short just prior to the ex-dividend date. Thereafter, the stock goes ex-dividend and the taxpayer makes the required in lieu payment. The stock will then drop in value by roughly the amount of the dividend and the taxpayer will close the short sale at a profit approximately equal to the "in lieu" expense. Section 263(h) recognizes that no ordinary expense and capital gain are actually present, and treats the transaction in accordance with its substance by capitalizing the in lieu expense.

The relief rule of section 263(h)(5) overrides the capitalization requirement where the taxpayer earns income on the "collateral" that consists of the proceeds of the short sale and such treatment is proper, since the amount of income earned on the collateral is an appropriate gauge of the portion of the in lieu payment that actually represents an expense for use of the stock sold short. Treating the in lieu payment as subject to section 263(g), however, would allow the in lieu expense to be offset by a variety of income items, which may or may not bear a relationship to the portion of the short sale expense "accrued" during the period that the short sale was open. Obviously, this problem is compounded in the case of a mixed straddle account, in which numerous unrelated income items may be present. Moreover, even

where a mixed straddle account is not involved, the determination of whether given positions are offsetting and therefore comprise a straddle is relatively subjective. As a result, taxpayers might take aggressive positions as to whether various income-producing assets are part of a straddle with a short stock position as to which an in lieu payment has been made, thereby permitting income items to reduce improperly the capitalization requirement.

In short, the Committee would reject the proposal as inconsistent with the purpose underlying section 263(h).

EXHIBIT A

Qualified Covered Calls Available at Time of Adoption of Tax Reform Act of 1984

1. Options Written with More Than 90 Days to Expiration

APPLICABLE STOCK PRICE
$150-1/8 - $200

Stock Price	Lowest Qualified Covered Call Strike Price(s)	Strike Prices as a Percentage of Stock Price
$200 - 190-1/8	180	90.00% - 94.67%
190 – 180-1/8	170	89.47% - 94.38%
180 - 170-1/8	160	88.89% - 94.05%
170 - 160-1/8	150	88.24% - 93.68%
160 - 150-1/8	140	87.50% - 93.26%

APPLICABLE STOCK PRICE
$25-1/8 - $150

$150 – 140-1/8	140	93.33% - 99.91%
140 – 130-1/8	130	92.85% - 99.91%
130 – 120-1/8	120	92.31% - 99.90%
120 – 110-1/8	110	91.67% - 99.89%
110 – 100-1/8	100	90.91% - 99.88%
100 – 95-1/8	90	90.00% - 94.61%
95 – 90-1/8	85	89.47% - 93.98%
90 – 85-1/8	80	88.89% - 93.98%
85 – 80-1/8	75	88.24% - 93.60%
80 – 75-1/8	70	87.50% - 93.18%
75 – 70-1/8	65	86.67% - 92.69%
70 – 65-1/8	60	85.71% - 92.13%
65 – 60-1/8	55	84.62% - 91.48%
60 – 55-1/8	55	91.67% - 99.77%
55 – 50-1/8	50	90.91% - 99.75%
50 – 45-1/8	45	90.00% - 99.72%
45 – 40-1/8	40	88.89% - 99.69%
40 – 35-1/8	35	87.50% - 99.64%
35 – 30-1/8	30	85.71% - 99.59%
30 – 25-1/8	25	83.33% - 99.50%

APPLICABLE STOCK PRICE
$25 OR LESS

$25 [23.53] – 20-1/8	20	85.00% - 99.38%
20 [17.64] – 15-1/8	15	85.00% - 99.17%
15 [11.76] – 10-1/8	10	85.00% - 98.77%
10 [5.88] – 5-1/8	5	85.00% - 97.56%

2. Options written with 90 Days or Less but More Than 30 Days to Expiration

APPLICABLE STOCK PRICE
IS $150-1/8 - $200

Stock Price	Lowest Qualified Covered Call Strike Price(s)	Strike Prices as a Percentage of Stock Price
$200 - 190-1/8	190	95.00% - 99.93%
190 – 180-1/8	180	94.74% - 99.93%
180 - 170-1/8	170	94.44% - 99.93%
170 - 160-1/8	160	94.12% - 99.92%
160 - 150-1/8	150	93.75% - 99.92%

APPLICABLE STOCK PRICE
IS $25-1/8 - $150

$150 – 140-1/8	140	93.33% - 99.91%
140 – 130-1/8	130	92.86% - 99.90%
130 – 120-1/8	120	92.31% - 99.90%
120 – 110-1/8	110	91.67% - 99.89%
110 – 100-1/8	100	90.91% - 99.88%
100 – 95-1/8	90	95.00% - 99.87%
95 – 90-1/8	85	94.74% - 99.86%
90 – 85-1/8	80	94.44% - 99.85%
85 – 80-1/8	75	94.12% - 99.84%
80 – 75-1/8	70	93.75% - 99.83%
75 – 70-1/8	65	93.33% - 99.82%
70 – 65-1/8	60	92.86% - 99.81%
65 – 60-1/8	55	92.31% - 99.79%
60 – 55-1/8	55	91.67% - 99.77%

55 – 50-1/8	50	90.91% - 99.75%
50 – 45-1/8	45	90.00% - 99.72%
45 – 40-1/8	40	88.89% - 99.69%
40 – 35-1/8	35	87.50% - 99.64%
35 – 30-1/8	30	85.71% - 99.59%
30 – 25-1/8	25	83.33% - 99.50%

APPLICABLE STOCK PRICE
IS $25 OR LESS

$25 [23.53] – 20-1/8	20	85.00% - 99.38%
20 [17.64] – 15-1/8	15	85.00% - 99.17%
15 [11.76] – 10-1/8	10	85.00% - 98.77%
10 [5.88] – 5-1/8	5	85.00% - 97.56%

EXHIBIT B

“In-the-Money” Qualified Covered Calls

Previous Day’s Closing Stock Price*	**Lowest Acceptable Stock Price****
$25 or less More than 30 days to expiration	One strike below previous day’s closing stock price (no in-the-money qualified covered call if strike price is less than covered 85% of stock price)
More than $25-$60 More than 30 days to expiration	One strike below previous day’s closing stock price
More than $60-$150 31-90 days to expiration	One strike below previous day’s closing stock price
More than $60-$150 More than 90 days to expiration	Two strikes below previous day’s closing stock price (but not more than $10 in-the-money)
More than $150 31-90 days to expiration	One strike below previous day’s closing stock price
More than $150 More than 90 days	Two strikes below previous day’s closing stock price