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TAX TREATMENT OF TRANSACTIONS IN OPTIONS

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TAX TREATMENT OF TRANSACTIONS IN OPTIONS

Summary

The Internal Revenue Service has ruled that where the writer of an option enters into a closing transaction he realizes ordinary income or loss based upon the difference between the amount of the premium which he received for the option he wrote, and the premium he paid for the option which he purchased.

Where an option is exercised, the premium is treated as part of the proceeds from the sale of the underlying stock, and is taxed as capital gain.

Since the decision of whether or not to enter a closing transaction is entirely within the discretion of the taxpayer, the revenue ruling described above has resulted in an opportunity for some taxpayers to plan tax strategies (described in more detail below) under which they realize ordinary loss on one part of a transaction, while realizing long or short term capital gain on another related transaction involving the same stock or securities.

In one often cited example, a taxpayer in the 50 percent tax bracket purchases 100 shares of IBM for $200 a share; he also writes a call on the stock at a striking price of $200 per share, for a premium of $2,500. If the value of the stock rises to $250 per share, and the taxpayer has held his stock for more than 6 months, he may sell the stock, realizing a long-term capital gain of $5,000 on which he owes $1,250 tax. He also enters a closing transaction with respect to his call by purchasing a call on IBM at a striking price of $200 per share; he would pay a premium of about $5,000 under these circumstances, and the resulting loss of $2,500 (determined by subtracting the premium the taxpayer received for the call he wrote from the premium he paid for the call he purchased) would be ordinary loss which could be offset against ordinary income for a tax saving of $1,250. The net result is that the taxpayer pays no tax on transactions producing a net economic income of $2,500.

H.R. 12224 would, in effect, reverse the 1973 private ruling with respect to closing transactions by providing that gain or loss from a closing transaction is to be treated as short-term capital gain or loss. Under the bill, this rule would apply to closing transactions which occur after March 1, 1976.

Nature and Economic Function of Put and Call Options

An option is the right to buy or sell stock or securities, or commodities (or other property) at a stated price for a fixed period of time. A "call" is the right to buy stock (or other property) at a stated price, and a "put" is the right to sell stock (or other property) at a stated price.

There are two parties to an option transaction, the "writer" of the option, and the "holder" or "buyer" of the option. The writer of a call obligates himself, for a fee (often called the "premium"), to sell stock for a stated price (often called the "striking price") for a stated period of time. For example, he might write a call to sell 100 shares of IBM for $200 per share, for a period of 3 months. The holder of the call pays the premium and obtains the right to buy the IBM stock, at the $200 per share price, for three months. A "put" is just the reverse of the call. The writer of the put promises to buy the IBM stock at $200 per share for a period of three months, and the holder has the right to sell to him at that price if he wishes to do so.

The holder of a call believes the market price of the stock may rise during the option period (in which case he will exercise his call and acquire the stock at a bargain price). The holder of a "put" feels the market price of a stock may decline, in which case his put will enable him to sell stock at more than its then current market value.

Basically, the obligations of an option writer may terminate in one of three ways, by exercise, lapse, or through a closing transaction. An exercise occurs where the holder of an option utilizes his right to make the writer of the option buy or sell stock at the agreed upon price. A lapse occurs where the holder does not exercise his option during the option period (usually because the holder has incorrectly predicted the trend of the market, so that the option is worthless) and the option period expires. A closing transaction occurs where the writer of the option acquires an offsetting option from another writer. For example, if X writes a call obligating himself to sell 100 shares of IBM at $200 per share, and the market price of IBM moves upward to $250, X could neutralize his own position with respect to IBM stock by acquiring a call from Y allowing X to purchase 100 shares of IBM from Y for $200 per share. (Of course, X would have to pay a greater premium to Y for this call than X himself had received because of the upward movement in the price of the underlying IBM stock.)

A call option is "in the money" if the current selling price of the stock exceeds the striking price of the option (so that the option gives the owner the right to buy the stock at a price below the current stock price). A call is "out of the money" if the current stock price is less than the striking price of the option.

Typically, an out-of-the-money call will sell at a positive premium, even though the stock is selling below the striking price of the option, because there is always some possibility that the stock will increase in price sufficiently to make the call "in-the-money." However, as time passes and the expiration date becomes more imminent, the premium generally declines close to zero. For example, on April 2, 1976, Ford Motor Company stock traded at 57¼. An option to buy Ford at 60 expiring October 16, 1976, sold at a premium of 4, while an identical option with a July 17, 1976 expiration date sold at 2⅝. Another case when the premium is usually small for an out-of-the-money call is when the stock price drops far below the striking price of the option so that a rise above the striking price is unlikely.

The "intrinsic value" of an in-the-money call is the difference between the current stock price and the striking price of the option. Typically, the premium will exceed the intrinsic value. For example, a Ford option expiring July 17 with a striking price of 50 had an

intrinsic value of 7¼ and sold at 8½ on April 2. The 1¼ point difference between the intrinsic value of the option and the premium results from the fact that buying the option is less risky than buying the stock because the loss on the option is limited to the premium even if the stock declines below the striking price of the option, while the potential loss on the stock is the entire purchase price.

Until recently, put and call options were traded exclusively "over-the-counter" through put and call brokers. The over-the-counter options are contracts between the specific buyer and specific writer. This means that while the buyer can exercise his option any time he wishes, the writer cannot relieve himself of his obligation except by repurchasing the specific option he has written. (The writer can, however, hedge by buying a similar option if he is willing to pay the relevant commissions.)

In 1973, trading began on listed options on the Chicago Board Options Exchange (CBOE). Unlike over-the-counter options, listed options consist of two contracts—one between the buyer and the CBOE and the other between the writer and the CBOE. A writer of a listed option can relieve himself of his obligation by buying a listed option identical to the one he has written. This is called a "closing transaction." The CBOE then cancels the two identical options. Currently the CBOE, the American Stock Exchange and the Philadelphia-Baltimore-Washington Stock Exchange all list call options, and they are expected soon to begin trading put options. The growth of listed options has significantly increased the liquidity of the options market from the standpoint of the writers, and the commission cost of listed options are below those of over-the-counter options.

The growth of options markets should have several beneficial impacts on the economy. Buying or writing options are ways to transfer risks of stock price changes. Whenever such a risk is transferred from someone who is unwilling to bear it to someone who is more willing to bear it, both persons are better off. Also, the existence of options markets, in which risks that some investors find undesirable may be transferred to someone else, should make investors more willing to invest in common stocks. Options provide a vehicle whereby some of the risks associated with equity investment may be accepted and others transferred through the options market. Option buying or writing is not inherently more or less risky than investing directly in common stocks, although options do permit the buyer or writer to assume different risks than are assumed by stock traders.

Present Law

The tax treatment of puts and calls under present law is based largely on several widely publicized private letter rulings issued to the Chicago Board Options Exchange (CBOE) in which the Internal Revenue Service interpreted the application of Internal Revenue Code sections 1233 (relating to short sales) and 1234 (relating generally to options to buy or sell), the regulations under those sections and previously published revenue rulings to option transactions. The rulings assume that options are capital assets in the hands of their holders, and that the securities which would underlie or would be acquired in connection with options are also capital assets in the hands of the holders or writers (sec. 1234(a)).

One aspect of the private rulings, the tax treatment of closing transactions, has significant tax planning potential. In a closing transaction, the writer (seller) of an option cancels his obligation under that option by purchasing from the exchange an option with terms identical to the option he had previously written. Under the Service's ruling, the difference between the amount paid in the closing transaction and the premium originally received by the option writer is ordinary income or loss.

The Service has also ruled that premium income from the lapse of an option is ordinary income to the option writer.

Issues

Under the present tax treatment of option and stock transactions, there are opportunities for an investor to structure his investment position according to the tax benefits which would result. The growth of options exchanges has greatly increased the options investor's flexibility and enables the sophisticated taxpayer to adjust his risks quickly and frequently according to market fluctuations in order to reduce his risks, to protect his investment, and to maximize his return.

In most transactions, nontax considerations, such as the cost of the options and stock, the commission cost of frequent hedging transactions, the unpredictability of market activity, and the investor's own ability to assume economic risks are so great that the ultimate tax consequences cannot be completely predicted or controlled by the investor and are outweighed by the nontax, economic factors involved in option transactions.

However, in certain situations, the tax treatment of options transactions arguably lends itself to tax-oriented investment practices. In this regard, the tax treatment of the closing transaction is most frequently cited as an opportunity for the investor to obtain maximum tax (and economic) benefits at little risk.

The main problems with existing law concern the tax treatment of option writers. When an out-of-the-money option lapses, the gain to the writer is ordinary income; also the gain or loss on an in-the-money option from a closing transaction is ordinary income or loss. The writer of an in-the-money call, however, often has the choice of relieving himself of his obligation in either of two ways: (1) he can execute a closing transaction, in which case his gain or loss is ordinary, or (2) he can allow the option to be exercised, in which case the option premium is added to the proceeds he eventually receives for selling the stock and is treated as a capital gain or loss. The capital gain or loss is short- or long-term depending on the length of time the stock has been held.[1] Thus, when the writer has a loss, he executes a closing transaction so

[1] This choice is not entirely that of the writer. An option buyer may decide to exercise an option; and since the CBOE assigns exercise notices randomly among the writers of each type of option, any particular writer always runs the risk of having his option exercised. This can have adverse results for the writer if the price of the stock is more than the striking price of the option, plus the call premium, because his loss in this case will be a capital loss and hence, not deductible against more than $1,000 of ordinary income. (Had the writer been able to execute a closing purchase transaction, his loss would have been an ordinary loss that is deductible against ordinary income.) Few options, however, are exercised until shortly before their expiration date, because they typically sell at premiums above their intrinsic value. A careful option writer, who deals in options selling above their intrinsic value, can eliminate virtually all risk of unwelcome exercise.

that the loss is an ordinary loss that is deductible against ordinary income. When the writer has a profit but the call option is still in the money, he allows the call to be exercised. In this case, his gain from writing the call is transformed into a short- or long-term capital gain.

In other cases, the individual may write a call on stock which he already owns; if the price of the stock increases, the writer will realize capital gain on the appreciation, and will close out the call, thus, suffering an ordinary loss. By realizing ordinary loss on a closing transaction and long-term capital gain on the sale of the stock underlying his closed-out option, a taxpayer is entitled to deduct the full amount of his loss from his other income, and to allow his economic gain on the sale of the stock to be taxed at preferential long-term capital gains rates.

The tax consequences of writing options can best be illustrated with some specific examples:

(1) *Writing a covered out-of-the-money option.*—Suppose Ford Motor Company stock is selling for 57¼ (as it was on April 2, 1976) and someone writes a call for 100 shares at 60 expiring October 16. On April 2 this option sold at a premium of 4. Assume the writer also buys 100 shares of Ford stock at 57¼. This is called an "option hedge." On a before-tax basis, the writer makes a profit of $4 per share if the stock price stays at 57¼, since he breaks even on his stock purchase and gains 4 on the option. (This example and those that follow disregard commissions.) The profit is ordinary income. At a price of 64, his pretax profit is 6¾, since he gains 6¾ on the stock and breaks even on the option. The profit is a long-term capital gain. His before-tax profit remains 6¾ for prices higher than 64, since for each point by which the stock price rises, the one-dollar gain on the stock is offset by a one-dollar loss on the option. However, the after-tax profit continues to increase because the gain on the stock is long-term capital gain, while the loss on the option (which is closed) is ordinary loss. For a taxpayer in the 50-percent bracket, the after-tax profit at a stock price of 64 is 5$^{1}/_{16}$. At a price of 70, when the pretax profit is still 6¾ (a gain of 12¾ on the stock and a loss of 6 on the option), the after-tax profit is 6$^{9}/_{16}$. At a price of 80, the pretax profit is 6¾, and the after-tax profit is 9$^{1}/_{16}$. Thus, for each dollar by which the stock price rises above 64, the writer converts a dollar of ordinary income into capital gain.

The tax law works against the taxpayer, however, if the stock price declines. The $4 option premium is ordinary income, but any loss on the stock (if it falls below 57¼) is a capital loss. (By selling the stock before it is held 6 months, the hedger can get a short-term capital loss.) Unless the individual has capital gains against which to deduct the loss, his deduction is limited to $1,000 each year.

(2) *Writing covered in-the-money options.*—The adverse tax consequences described above can be minimized by writing in-the-money options, which will be exercised unless there is an extremely large drop in the stock price. Assume that on April 2, 1976, an individual buys 100 shares of Ford at 57¼ and writes a call option for 100 shares of Ford with an October 16 expiration date and a striking price of 45. This option sold for a premium of 12¾ on April 2. The intrinsic value of this option is 12¼ (the difference between the stock price of 57¼

and the striking price of 45). If the stock price rises, the writer will have a pretax profit of ½ per share. His after-tax profit will increase, however, as the stock price increases because of the fact that the loss on his option is deductible from ordinary income, while the gain on his stock is long-term capital gain. For each dollar by which the stock price increases above 57¼, the hedger converts a dollar of ordinary income into long-term capital gain. At a price of 80, the gain on the stock is 22¾ and the loss on the option is 22¼, leading to a pretax profit of ½ but an after-tax profit of 5 15/16.

If the price of Ford declines, the writer should allow the option to be exercised. If the price falls to 50 and the option is exercised, the writer uses the stock he bought at 57¼ to fulfill the option contract. His basis in the stock is 57¼, and the price he receives is considered to be the 45 for which he sells the stock plus the 12¾ premium he received for the option, or 57¾. Thus, he has a capital gain of ½. As long as the stock price does not fall below 45, the writer has a pretax profit of ½, taxed at long-term capital gains rates. Only if the stock price falls below 45 is the writer faced with a situation where he has ordinary income on the option and capital loss on the stock. Even this case is not a problem if he has other capital gains against which to deduct the loss.

(3) *Option spreads.*—A "spread" consists of writing one option and buying another option on the same underlying stock. Suppose someone writes a call option on April 2, 1976, to buy 100 shares of Ford stock at 45 for a premium of 12¾ and on the same date buys an option to buy 100 shares of Ford at 50 for a premium of 9¼. Both options have expiration dates of October 16, and the price of Ford stock was 57¼ on April 2.

If Ford stock rises in price above 59½, there will be a gain on the purchased option, which will be taxed as a long-term capital gain. The loss on the written option will be an ordinary loss (because there will be a closing transaction). For each dollar of price increase above 59½, the writer converts a dollar of ordinary income into capital gains. Thus, if the stock price rises to 80, the before-tax profit on the purchased option is 20½, and the before-tax loss on the written option is 22¼. The net pretax loss, then, is 1¾. After taxes, however, the profit on the purchased option is 15⅜ (for a 50 percent bracket taxpayer), since the gain is a long-term capital gain, while the after-tax loss on the written option is 11⅛. The net after-tax profit, therefore, is 4¼ even though the pretax loss is 1¾. If the spread is set up in June, the loss can be realized through a closing purchase transaction in December, while the gain is realized in January, which also gives the spreader a one-year deferral of the tax on the gain.[2]

The tax consequences of a spread may be adverse, however, if the stock price declines. If the stock declines to 45, there is a 9¼ loss on the purchased option and a 12¾ gain on the written option, for a pretax profit of 3¼. (Because the pretax profit is positive when the stock price falls sharply or negative when it rises or declines only slightly, this is termed a "bearish spread.") However, the gain on the written option is ordinary income (because it results from an option lapse) while the loss on the purchased option is short-term capital loss (as-

[2] Under present law, in the case of a cash basis taxpayer, loss is generally recognized on the trade date, while gain is recognized on the settlement date (when the stock or other property is delivered). Since the settlement date generally occurs after the trade date, a one year deferral may be obtained when a spread is disposed of at the end of a taxable year.

suming the spread is closed out before six months have elapsed). Unless the taxpayer has other capital gains, the deduction of the short-term capital loss is limited to $1,000. For this reason, the bearish spread is not very attractive to taxpayers without short-term capital gains, although the relatively small capital outlay needed to set up a spread makes it quite attractive to these taxpayers.

The tax benefits in each of these examples would be greater if a 70-percent marginal tax rate were assumed, instead of a 50-percent rate, and if it were assumed that the taxpayer was eligible for the 25-percent alternative rate on his long-term capital gains (that is, his gains were less than $50,000). Commissions, however, reduce the tax benefits.

Effect of H.R. 12224.—H.R. 12224 provides that gain or loss from a closing purchase transaction would be taxed as a short-term capital gain or loss rather than as ordinary income. The amendments made by H.R. 12224 would apply to closing transactions which occur after March 1, 1976.

The effect of this change would eliminate the feature of existing law that permits conversion of ordinary income into capital gains. In the case of the writer of a covered in-the-money call (as described in example 2 above), when the price of the underlying stock increases, the gain on the stock would continue to be long-term capital gain but the loss on the option would be a short-term capital loss. The short-term loss could be deducted against the long-term capital gain, but not against ordinary income (except to a limited extent).

This would not eliminate all of the tax advantage of option hedges. For an individual with short-term capital gains, the combination of short-term capital losses and long-term capital gains provided by the option hedge is very helpful. The short-term capital loss can be deducted against the short-term gains, which would otherwise be taxed as ordinary income, while the long-term gain is eligible for the 50-percent exclusion. For people without short-term gains, however, the short-term capital loss on the written option would have to be deducted against the long-term capital gain on the stock.

Suggested modifications to H.R. 12224

Treatment of income from lapsed options, etc.—Under the ruling issued to the Chicago Board Options Exchange, premium income from a lapsed option is treated as ordinary income to the option writer. At the hearing on H.R. 12224 held April 5, 1976, it was suggested that if the gain or loss on closing transactions is to be treated as short term capital gain, premiums for lapsed options should receive similar treatment. It was pointed out that under the bill, an alert writer of an option which was about to lapse could enter a nominal closing transaction and achieve capital gains treatment by purchasing (at a very low premium) an essentially worthless option having the same terms as the option which he had written.[1]

If ordinary income treatment for premium income from lapsed options is preserved, the treatment of nominal closing transactions would present problems.

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[1] For example, assume that X writes a call to sell 100 shares of IBM at $200 per share for a premium of $1,000. The price of the stock falls to $180 per share so that the call is worthless. Just before the call expires, X purchases a call giving him the right to buy 100 shares of IBM at $200 per share (for a premium of perhaps $10). His profit of $990 would be capital gain.

Conceptually, it is hard to identify a "capital asset" in the hands of the writer of an option. But apart from conceptual problems, allowing premium income from lapsed options to be treated as short term capital gain will solve a serious problem for some investors by allowing them to offset this income against any capital losses which they may have incurred.[2] Under present law, a person who has substantial capital losses may not offset those losses (except to a very limited extent) against premium income, even if the capital losses result from transactions in stock underlying covered options.[3] An amendment to H.R. 12224 permitting short term capital gain treatment for premium income would prevent this situation in the future.

If this change is made, section 1234(c) of the code, providing for short-term capital gain treatment in the case of lapses in straddle situations, will become superfluous.

At the hearing, it was also suggested that capital gain and loss treatment should not apply to persons who trade in options in the ordinary course of their trade or business (on the theory that such persons are not engaging in capital transactions with respect to options; the writing and holding of options, in the case of these persons, is more nearly analogous to trading in inventory or other property held for sale to customers). As a technical matter, this would appear to be the result under H.R. 12224 as drafted, since section 1234 of the code, which is the section amended under the bill, does not apply in the case of transactions in options held as inventory or as other property held for sale to customers in the ordinary course of a trade or business. However, there appears to be no objection to making this point more explicit.

Short or long term capital gains on options.—Another suggested modification of H.R. 12224 would provide that gain or loss on closing transactions could be long or short term depending on the period during which the option was outstanding. However, this approach might create more manipulative possibilities of the type which H.R. 12224 is attempting to prevent. In the case of a loss situation, the taxpayer could always execute a closing purchase transaction before the expiration of the required long term holding period to obtain short term capital loss treatment. In the case of a covered call, if the price of the stock went up, the taxpayer would close on the call within six months (thus, obtaining short term capital loss treatment) while holding the underlying stock for 6 months and a day, thus obtaining long term capital gain treatment on the stock with minimal investment risk. While the manipulative possibilities involved under this proposal are not as great as under present law (where the taxpayer may, under certain circumstances, obtain long term capital gain and ordinary loss) there appears to be little reason (as representatives of industry have testified) to encourage any trading in options based

[2] In a sense, this is part of a larger problem concerning the extent to which capital losses should be permitted to offset ordinary income. The committee dealt with a part of this problem in section 1401 of the Tax Reform Act of 1975, H.R. 10612, by increasing the current $1,000 limitation on the amount of this offset to $4,000. The problem of the proper tax treatment of capital gains and losses is probably too complex to be dealt with in the context of this bill, but it should be noted that the amendment to H.R. 12224 outlined above would mitigate the problem of offsets substantially in the area of options.

[3] For example, assume that X purchases 1,000 shares of IBM at $200 per share and writes a call on the stock at that price, receiving a premium of $10,000. If the stock declines to 190, the call will lapse (because it is worthless) and, under present law, X will have ordinary income of $10,000. If he sells the IBM stock, he will also have a $10,000 capital loss but, under present law, only $1,000 of this amount could be offset against the income from writing the call.

on tax strategies rather than on the economic soundness of the investment.

Trading in options by regulated investment companies.—Under present law, regulated investment companies are treated in many respects as a conduit to their shareholders; that is, the mutual fund itself is not subject to tax on income which it distributes to shareholders. Instead, the shareholders are taxed, and the income received by the shareholders generally has the same character in their hands (long or short term capital gain, dividends, interest, etc.) as it would have had if the shareholders had made the underlying portfolio investments directly, rather than through the mutual fund. The purpose of these rules is to give the average investor an opportunity to participate in a diversified portfolio.

However, regulated investment companies are also subject to a number of rules and restrictions with respect to their operations. Among these rules is a requirement that at least 90 percent of gross income must be derived from dividends, interest, and gains from the sale of "stock or securities" (sec. 851(b)(2) of the code). The purpose of these and other requirements is to help ensure that the regulated investment company is essentially engaging in passive investment activities, and is not operating as a normal business corporation.

The Service has ruled in Rev. Rul. 63–183, 1963–2 C.B. 285, that amounts derived by a regulated investment company from writing put and call options which lapse do not constitute gains from the sale or other disposition of stock or securities within the meaning of section 851(b)(2).[1] Accordingly, a corporation will not qualify as a regulated investment company if more than 10 percent of its gross income consists of premiums from the writing of puts and calls which lapse.

H.R. 12224 does not address itself directly to this issue. A literal reading of the bill (assuming it were modified to cover lapse transactions, as outlined above) might suggest that premium income would remain nonqualifying income because the bill provides that it is to be treated as income from the sale or exchange of a "capital asset" (not from the sale or exchange of "stock or securities").

To the extent that any concern in this area centers on whether the mutual fund is engaged in passive investment activity, there would appear to be no problem involved in providing that mutual funds could trade in options.

However, some have suggested that there might be other possible problems if the rules in this area were to be modified. For example, some are concerned that mutual funds might engage in "speculative" high risk option writing activities. Others are concerned that mutual funds might dominate the still developing options market, if activities in this area were totally unrestricted.

These problems could be minimized if qualifying income (for purposes of the 90 percent income source test for regulated investment companies) were limited to income from the lapse of covered options. To the extent that speculation is the concern, the writing of a covered call, far from being speculative, can be a means of protecting the mutual fund's unrealized appreciation in a particular stock. It is also unlikely that a mutual fund will obtain undue market dominance if its

[1] If a call is exercised, the premium would be treated as income received by the mutual fund on the underlying stock.

activities are limited to the writing of covered options.[2] This approach of characterizing income from the writing of covered options as qualifying income would also be consistent with the decision which the committee made in connection with exempt organizations (in H.R. 3052).[3]

Tax Treatment of Foreign Option Writers.—Present law provides, in general, that interest, dividends and other similar types of income of a nonresident alien or a foreign corporation are subject to a 30-percent tax on the gross amount paid if the income or gains are not effectively connected with the conduct of a trade or business within the United States (secs. 871(a) and 881). This tax is generally collected through withholding by the person making the dividend, interest or other payment to the foreign recipient of the income (secs. 1441 and 1442).

Nonresident alien individuals are only subject to tax on their noneffectively connected capital gains if they are present in the United States for 183 days or more during the taxable year. Those capital gains which are subject to tax (because of the 183 day rule) are subject to a 30-percent tax on the net amount of the gains and losses for the year. Also, corporations are not subject to tax on their noneffectively connected capital gains from the sale or exchange of securities. Any income or gain of a foreign person which is effectively connected with the conduct of a trade or business within the United States is subject to the regular individual or corporate tax rates as the case may be (sec. 871 or 881 or 882). However, the trading in stocks or securities by a foreign investor for his own account is not to be deemed engaging in a trade or business within the United States.

The rules under present law dealing with the tax treatment of income derived by a foreign person from the writing of an option are not clear in all situations. For example, if a call option written by a foreign investor is exercised, then the premium is considered as part of any gain realized by the foreign investor from the sale of the underlying stock and the investor is only subject to U.S. tax on the gain if present in the United States for 183 days or more, or if the gain was effectively connected with the conduct of a trade or business within the United States. In neither case will a 30-percent withholding tax on the gross amount of the premium from writing the option be imposed. A tax would either be imposed at a 30-percent rate on the net amount of gain for the entire year (by reason of the 183 day rule), or at the applicable individual or corporate rates (in the event of effectively connected capital gains). On the other hand, the tax treatment under present law with respect to gain or loss realized on the lapse of an option or in a closing transaction is unclear. Some have concluded that the premium is subject to the 30 percent tax on gross while others have concluded that the premium is not subject to this tax.

It is not administratively feasible to impose a 30-percent withholding tax on the amount of the premium because when the premium is paid it is unknown whether the option will be exercised, will be allowed to lapse, or will be subject to a closing transaction. The tax

[2] The mutual fund would not be prohibited from writing uncovered options under this approach, but the premium income would not be qualifying income for purposes of the income source test.

[3] As a result of the committee action on H.R. 3052, a technical amendment will be required to H.R. 12224.

treatment on income derived from the writing of the option should be the same regardless of how the transaction is finally completed. The proposal (recommended by Treasury and essentially reflected in H.R. 12224) to treat the gain from the lapse or closing of an option as capital gain would result in the exemption of the grain from U.S. tax in most instances. This tax treatment would be consistent with the treatment of gain from the exercise of an option.

Effective date.—Under H.R. 12224, the new rules are to apply to closing transactions which occur after March 1, 1976 (the bill was introduced on March 2). The purpose of this rule was to discourage a rush in speculative activity in this area before the committee had had an opportunity to consider the matter.

On the other hand, this effective date has produced some uncertainty (because investors cannot be sure whether and when the committee will act) in a market where great certainty as to the Federal tax treatment is desirable. Thus, the committee may wish to consider a modification of the effective date, applying the new rules to options which are written after the date of the committee's decision on this bill.

Administration Proposal

The Treasury Department supported H.R. 12224 in its testimony but made the following recommendations with respect to the bill:

(1) It suggested that the bill be amended to provide short-term capital gain treatment for income realized by the writer of a put or call which lapses. (Under present law, this is ordinary income.)

(2) It pointed out that the bill could have an impact on the tax treatment of exempt organizations and regulated investment companies with respect to options.

(A) With respect to exempt organizations, Treasury noted that the committee has already resolved this issue when it decided to favorably report H.R. 3052, which would exclude income from the lapse of an option from the unrelated business income tax, and that the committee had decided to limit this exclusion to covered options.

(B) In the case of regulated investment companies, Treasury suggested the committee give consideration to the question of whether these companies should be permitted to treat income from writing options as qualifying income.

(3) It suggested that the bill be amended to provide expressly that gains or losses by persons who trade in options in the ordinary course of their trade or business would continue to be ordinary gains or losses (rather than short-term capital items).

(4) With respect to the treatment of foreign investors, Treasury suggested that it be made clear that premium income from the writing of options would not be subject to withholding.

(5) With respect to the effective date, Treasury suggested that the change in tax treatment apply to options written after the date of the committee's decision with respect to the bill.

Proposals Submitted by Interested Persons to Committee

The following is a general summary of the views submitted to the committee on behalf of interested persons at the public hearing con-

ducted on April 5, 1976. In general, the views and proposals of those who testified at the hearing relate to the provisions of H.R. 12224.

Chicago Board Options Exchange, represented by Joseph W. Sullivan, President.

(1) Generally supports the principles of tax consistency and neutrality with respect to trading in options and believes those principles are reflected in H.R. 12224, although certain modifications to that bill are needed. Believes that the options market must exist for sound economic and investment purposes (rather than to facilitate tax strategies).

(2) Recommends that the bill be amended to provide specifically that income realized by the writer of an option upon lapse should be treated in the same manner as gain or loss on a closing transaction because these are essentially alternative means of realizing the same income, and failure to do this would continue nonneutrality of tax treatment in this area.

(3) With respect to the effective date, urges that the bill not be retroactive and suggests that the bill should apply only to lapses and closing transactions for options written after the date of enactment; alternatively suggests the bill might apply to lapses and closing transactions which occur after the date of enactment.[1]

American Stock Exchange, represented by Robert J. Birnbaum, Executive Vice-President.

(1) Generally supports H.R. 12224, with certain modifications, because of its potential simplification and neutralization of the tax treatment of option trading.

(2) Recommends that the bill be amended to provide that income from the lapse of an option would be treated as capital gain. Also recommends that gain from an option lapse, and gain or loss from a closing transaction should be long or short term, depending on the period during which the investor was obligated under the option.

(3) Urges that the provisions of the bill not apply retroactively, and suggests that any new rules in this area apply to options written after the date of enactment.[2]

Taxation with Representation, represented by Thomas J. Reese.

Strongly supports H.R. 12224.

Arthur Rosenberg (for himself).

Generally supports the provisions of H.R. 12224.

Harrison H. Noble (for himself).

Suggests several approaches as possible alternatives to the approach in H.R. 12224. One approach would retain ordinary income or loss treatment for income derived from the sale of options, but modify the tax treatment of gain from the sale of stock which "covers" an option. Another suggested approach would treat income from the sale of options as long or short term capital gains, depending on the holding period.

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[1] Mr. Sullivan also made two technical suggestions; first, that section 1234(c) of the code (treating income from lapses of straddles as short-term capital gain) may be superfluous if the bill is amended to cover income from option lapses; second, that taxpayers who write options in the ordinary course of their trade or business should not be accorded capital gain treatment.

[2] It was also suggested that capital gain or loss treatment should not apply to dealers in options. Certain technical suggestions were also offered.

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