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TAXATION OF CAPITAL GAINS AND LOSSES

SCHEDULED FOR HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS

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PREPARED BY THE STAFF

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OVERVIEW

This pamphlet, prepared by the staff of the Joint Committee on Taxation, addresses four issues related to the tax treatment of capital gains and losses, about which the House Committee on Ways and Means is scheduled to hold a hearing on November 2, 1983. The issues are (1) the holding period determining long-term capital gains and losses, (2) the tax treatment of capital losses, (3) the tax treatment of options, and (4) a new Canadian proposal for taxing gains and losses on corporate stock.

Holding period.—Presently, the holding period distinguishing between short-term and long-term capital gains is one year. Long-term gains receive preferential tax treatment. Proposals have been made to shorten the holding period to 6 months. Also, there are certain tax-motivated transactions that permit taxpayers to "convert" short-term into long-term capital gains, and Treasury has made suggestions about how these transactions might be restricted.

Capital losses.—Capital losses may be deducted against capital gains and up to $3,000 per year of ordinary income. It has been suggested that the $3,000 limit be reduced to $1,000. Also, taxpayers have been engaging in transactions designed to "convert" capital losses, whose deductibility is limited, to ordinary losses not subject to the $3,000 limit. Treasury has proposed ways of restricting such transactions.

Stock options.—Stock options (and stock itself) are exempt from the present rules designed to restrict tax-motivated straddle transactions. Treasury has suggested that this exemption be eliminated. Also, the tax treatment of commodity options is unclear, and Treasury has proposed that it be clarified. The Chicago Board Options Exchange (CBOE) has submitted a legislative proposal designed to restrict straddles in options, clarify their tax treatment and create a competitive balance between options and futures contracts.

Canadian proposal.—The recent Canadian budget contains an innovative proposal for taxing capital gains on Canadian stocks on a mark-to-market basis. This proposal would address several of the problems raised under the U.S. system in connection with the holding period and the treatment of capital losses.

I. HOLDING PERIOD FOR LONG-TERM CAPITAL GAINS

Present Law

General rule

Under present law, gain or loss from the sale or exchange of a capital asset which has been held for more than one year receives special tax treatment. For this purpose, the term "capital asset" generally means any property held by the taxpayer. However, capital assets generally do not include (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, or (5) certain U.S. publications. Although depreciable personal property and real property used in a trade or business are not capital assets, gains from sales, exchanges or involuntary conversions of those assets (in excess of depreciation recapture) may be treated as capital gains under certain circumstances.

Noncorporate capital gains tax

Noncorporate taxpayers may deduct from gross income 60 percent of the amount of any net capital gain for the taxable year, i.e., 60 percent of the excess of net long-term capital gain over net short-term capital loss. (Long-term capital gain is defined as gain from the sale or exchange of a capital asset held for more than one year.) The remaining 40 percent of the net capital gain is included in gross income and taxed at the otherwise applicable regular income tax rates. As a result, the highest tax rate applicable to a noncorporate taxpayer's entire net capital gain is 20 percent, i.e., 50 percent (the highest individual tax rate) times the 40 percent of the entire net capital gain includible in adjusted gross income.

Corporate capital gains tax

An alternative tax rate of 28 percent applies to a corporation's net capital gain (the excess of net long-term capital gain over net short-term capital loss) if the tax computed using that rate is lower than the corporation's regular tax. The highest regular corporate tax rate is 46 percent for taxable income over $100,000.

Minimum taxes

Alternative minimum tax for noncorporate taxpayers

Under present law, noncorporate taxpayers are subject to an alternative minimum tax to the extent that it exceeds their regular income tax. The alternative minimum tax is based on the taxpayer's adjusted gross income and increased by tax preference items, including the 60 percent of net capital gains deducted in computing the regular tax. The alternative minimum tax rate is 20 percent for amounts in excess of a specified exemption amount.

Corporate "add-on" tax

Present law imposes an "add-on" minimum tax for corporations on certain tax preference items. 18/46ths of a corporation's net capital gain is a tax preference subject to the minimum tax.

Legislative History

Reduced tax rate for capital gains

Noncorporate capital gains have been taxable at reduced rates since the Revenue Act of 1921. That Act provided for a maximum 12.5 percent tax on gain on property held for profit or investment for more than 2 years (excluding inventory or property held for personal use). Because of the relatively low tax rates on ordinary income in this period, this provision benefited only higher bracket taxpayers.

The present system of capital gains taxation dates largely from the Revenue Act of 1942. The 1942 Act provided for a 50 percent exclusion for noncorporate capital gains or losses on property held for more than 6 months. The Act also included alternative ceiling rates on capital gains taxes for noncorporate and corporate taxpayers. The basic structure of the 1942 Act was retained under the Internal Revenue Code of 1954.

The Revenue Act of 1978 increased the exclusion for noncorporate long-term capital gains from 50 to the present 60 percent. Together with concurrent changes in the noncorporate minimum tax, this had the effect of reducing the highest effective rate on noncorporate capital gains from approximately 49 percent to 28 percent. (The reduction in the maximum rate on earned income from 70 to 50 percent under the Economic Recovery Act of 1981 (ERTA) reduced the maximum effective capital gains rate from 28 percent to 20 percent.) The 1978 Act also set the alternative capital gains tax for corporations at its present level of 28 percent.

Holding period

Under the Revenue Act of 1921, the alternative maximum rate for capital gains applied to property held for more than 2 years. Since that time Congress has, on several occasions, adjusted the holding period required for reduced capital gains taxation.

The Revenue Act of 1934 provided for exclusion of varying percentages of capital gains and losses depending upon the period for which an asset was held. Under that Act, 20 percent of capital gains were excludible if an asset was held for 1 to 2 years, 40 percent if an asset was held for 2 to 5 years, and 60 percent if the asset was held for between 5 and 10 years. Where an asset had been held for more than 10 years, 70 percent of capital gains were excluded.

The Revenue Act of 1938 provided for two classes of long-term capital gains. For assets held for 18 months to 2 years, a 33 percent exclusion was allowed. Where assets were held for more than 2 years, a 50 percent exclusion was provided. No exclusion was allowed for assets held for 18 months or less. The 1938 Act also provided alternative ceiling rates applicable to the same holding periods as the capital gains exclusions.

In the Revenue Act of 1942, Congress eliminated the intermediate holding period for capital gains purposes. The 1942 Act provided for two categories of capital assets: assets held for more than 6 months (long-term capital assets), for which a 50 percent exclusion was allowed, and assets held for 6 months or less (short-term capital assets) for which no exclusion was provided. The alternative tax rates on individual and corporate net capital gains (i.e., the excess of net long-term capital gains over short-term capital losses) were based upon the same 6-month holding period.

A 6-month holding period for long-term capital gains treatment remained in effect from 1942 through 1976. However, the Tax Reform Act of 1976 increased the holding period to 9 months for 1977 and one year for 1978 and all subsequent years. The provision was a modified version of the provision originally included in the House version of the bill.

Analysis

Analysis of whether it is appropriate to differentiate the tax treatment of capital gains and losses based on the length of time the asset is held generally begins with an analysis of why capital gains and losses should be treated differently than other kinds of income. The various arguments for preferential treatment of capital gains have different implications for whether a holding period distinction is appropriate and, if so, what that holding period should be.

Bunching.—One argument for a reduced tax rate on capital gains is that, in the case of gains on assets with long holding periods, income that has accrued over a long period of time is taxed in one year. With graduated tax rates, such bunching can lead to a higher tax burden than if the gain were taxed as it accrued. (The tax penalty from bunching is offset, to some extent, by the tax benefit resulting from deferring the tax on an accrued gain until the asset is sold.) Hence, it is argued, a preferential tax rate on capital gains is appropriate. Since bunching is clearly not a problem for assets held for less than one year, this line of reasoning suggests a one-year holding period. The House committee report on the Tax Reform Act of 1976 presented this argument for lengthening the holding period from 6 months to one year.

Lock-in.—A second argument for a reduced tax rate on capital gains is that, because the decision to sell an asset is usually at the discretion of the taxpayer, high rates on capital gains are counterproductive in that they discourage sales of assets and raise less revenue than would lower tax rates. The legislative history of the 1978 reductions in capital gains tax rates suggests that this lock-in effect was an important consideration in Congress' decision to lower capital gains taxes that year, and the data on tax returns for the years 1979 through 1981 show a significant increase in realization of capital gains, enough to be consistent with the proposition that the 1978 capital gains tax cuts did not lose revenue for those years.

Requiring a minimum holding period for the preferential tax treatment accorded capital gains also produces a lock-in effect, and the shorter the holding period the shorter will be the period for which taxpayers have an incentive to delay selling appreciated assets. However, the data available from tax returns for the years 1977 through 1981 show a sizable increase in the quantity of short-term capital gains following the lengthening of the holding period in 1976. Net short-term gains increased from $1.2 billion in 1976 to $1.7 billion in 1977, $2.9 billion in 1978, $3.4 billion in 1979 and $5.8 billion in 1980, although they declined to $4.3 billion in 1981. These data suggest that the greater lock-in effect of the longer holding period was not enough to prevent it from increasing revenues. However, the recent introduction of stock index futures and options may increase the willingness of individuals to delay realizing short-term capital gains because they will have the opportunity to hedge their positions in the futures or options markets.

Incentives for equity investment.—A third argument for preferential capital gains tax rates is that they encourage investors to buy corporate stock, especially in new companies. This argument was also important in the 1978 debate over capital gains taxes, and there has been a large growth in the availability of venture capital since 1978. Advocates of a shorter holding period argue that it would provide further encouragement to investors to buy equities because it would increase the probability that capital gains would receive the preferential tax treatment. Others argue that a longer holding period would encourage more patience on the part of investors and less concern with short-term fluctuations in prices.

Inflation.—Another argument for preferential tax treatment for capital gains is that part of such gains simply represent the effects of inflation and do not constitute real income. This argument was also important in 1978. The inflation argument, however, does not have very significant implications for the appropriate holding period, since there is no particular reason why the fraction of a capital gain that represents inflation should vary systematically with the holding period.

Protection against tax-motivated transactions.—One problem with preferential tax treatment for capital gains is that it encourages taxpayers to undertake transactions designed to convert ordinary income into capital gains. The tax law contains numerous provisions designed to limit such conversion, the most recent of which are the tax straddle provisions enacted in 1981. A holding period requirement may reduce the motivation of taxpayers to engage in such transactions by exposing him to greater market risk, and the longer the holding period the greater is the deterrence. However, it is not clear by how much the 6-month holding period would differ from the present law in this respect.

Distributional impact.—Table 1 shows the impact of reducing the holding period to 6 months by income groups, estimated at 1982 levels of income. There would be 567,000 taxpayers experiencing tax reductions amounting to $223 million. 290,000 taxpayers would experience tax increases amounting to $19 million because their short-term capital losses would be converted to long-term losses. Of the net tax cut, 43 percent would go to taxpayers whose income exceeds $100,000.

Table 1.—Reduction in the Holding Period for Long Term Capital Gains to 6 Months

1982 Income Levels

[Returns in thousands, dollar aggregates in milions]

Expanded income [1] class	Tax decrease			Tax increase			Net tax change	Percent of total distribution
	Returns	Amount	Average	Returns	Amount	Average		
Under $10,000	20	−3	−100	32	$1	$31	−1	.5
$10,000 to $20,000	77	−14	−182	33	2	61	−13	6.4
$20,000 to $30,000	91	−15	−165	43	2	47	−13	6.4
$30,000 to $40,000	70	−9	−129	62	4	65	−5	2.5
$40,000 to $50,000	73	−28	−384	36	5	139	−23	11.3
$50,000 to $75,000	111	−43	−382	48	2	42	−41	20.2
$75,000 to $100,000	44	−21	−477	19	1	53	−20	9.8
$100,000 to $200,000	56	−39	−696	14	1	71	−38	18.7
$200,000 and over	25	−50	−2,000	3	1	333	−49	24.1
Totals	567	−223	−393	290	19	66	−204	100

[1] Expanded income equals adjusted gross income plus excluded capital gains and various other preference items less investment interest to the extent of investment income.

Revenue impact.—The revenue estimates in table 1 are not purely static because they assume some response by taxpayers in adjusting their transactions to the shorter holding period. When adjusted to current levels of income and if the shortening of the holding period is made effective for assets purchased after November 1, 1983, the revenue loss from the 6-month holding period is estimated to be negligible in fiscal year 1984, $140 million in 1985 and $251 million in 1986.

These revenue estimates have been criticized on several grounds. First, it is argued that they understate the additional revenues that would result from the reduced lock-in effect. However, as noted above, the estimates do contain some adjustment for taxpayer response to the tax change, and the data on gains realized after the 1976 lengthening of the holding period do not indicate that this additional revenue would be nearly enough to offset the revenue loss. Second, it is argued that the estimates understate the revenue gained as a result of the fact that a 6-month holding period would redefine some short-term capital losses as less valuable long-term losses. As shown in table 1, the estimates include some allowance for this effect; however, they do not properly account for the fact that a 6-month holding would speed up the rate at which taxpayers would use up their capital loss carryovers. This would not affect the revenue estimate for the initial year but would reduce the estimated revenue gain in future years. Unfortunately, there is no data with which to make a quantitative estimate of the size of this bias in the estimates. The staff believes that it is small for at least the first few years.

Transactions in mutual fund shares.—It should be noted that Treasury has recommended that Congress act to eliminate one method of converting short-term capital gains into long-term capital gains by purchasing mutual fund shares just before the fund pays a long-term capital gains dividend. A taxpayer who engages in this transaction gets a long-term capital gain from the dividend and a short-term capital loss when the shares in the fund are sold. The short-term loss can be deducted against a short-term gain, in effect "converting" it into a long-term gain. Presently, taxpayers need to hold the fund for only 31 days to achieve these tax benefits, and Treasury has recommended a 6-month holding period.

II. TREATMENT OF CAPITAL LOSSES

Present Law

Noncorporate taxpayers

Under present law, capital losses of noncorporate txpayers are deductible in full against capital gains. However, such losses may be deducted against a maximum of $3,000 (or, if lower, taxable income computed generally without regard to capital gains and losses) of ordinary income in each year. In determining the amount of capital losses which may be deducted from ordinary income, only 50 percent of net long-term capital losses in excess of net short-term capital gains (i.e., gains on property held for less than one year) may be taken into account. Capital losses in excess of these limitations may be carried over to future years indefinitely, but may not be carried back to prior years.

Corporate taxpayers

Present law allows a corporation to deduct capital losses only against capital gains. Net capital losses of corporations may generally be carried back for 3 taxable years and carried forward for 5 taxable years.

Trade or business property

A special rule (sec. 1231) applies to gains and losses on property used in a trade or business, property held primarily for sale to customers, property subject to compulsory or involuntary conversions and certain other kinds of property. Net gains from such property are treated as long-term capital gains but net losses are treated as ordinary losses.

Legislative History

Individual capital losses

In the early years of the income tax, losses from investments not connected with a trade or business were not deductible even against gains from similar transactions. This rule was changed in 1916 to allow deductions for transactions entered into for profit (but only to the extent of gains from similar transactions). The rule was further adjusted by the Revenue Act of 1918 to allow "net losses" to be deducted against capital gains or other income. For this purpose, "net losses" included capital losses arising from activities which contributed to the defense effort in World War I.

The Revenue Act of 1921 provided that net capital losses were deductible in full against capital gains or ordinary income. Because capital gains at this time were taxable at a maximum 12.5-percent rate, but capital losses could be used to offset income taxable at higher rates, this rule resulted in substantial revenue loss. Accord-

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ingly, the rule was amended by the Revenue Act of 1924 to limit the tax benefit from capital losses to 12.5 percent of the amount of such losses. The 1924 Act also repealed the previously existing carryforward for excess capital losses.

Under the Revenue Act of 1934, the percentage exclusion for net capital gains was made dependent upon the length of time for which the property was held (see discussion above). In conjunction with this change, the Act allowed equivalent percentages of capital losses to be deducted against capital gains and, in the event of any excess, against $2,000 of ordinary income. The $2,000 limit on the amount of ordinary income against which capital losses could be deducted was motivated by the fact that some very wealthy investors had been able to eliminate all their income tax liability by deducting losses incurred in the stock market crash against ordinary income.

The Revenue Act of 1938 introduced the present law concept of net long-term and short-term capital losses. Under the 1934 Act, net long-term capital losses (i.e., losses on property held for more than 18 months) could be deducted in determining a taxpayer's overall net income. The amount of the deduction was equivalent to the amount of the gain which would be taken into account on equivalent transactions, i.e., 66⅔ percent for property held between 18 months and 2 years and 50 percent for property held longer than 2 years. However, the overall reduction in tax liability by reason of such losses could not exceed 30 percent of such losses. Short-term losses could be deducted only against short-term gains (with a one-year carryforward).

The next major change in the treatment of capital losses was made by the Revenue Act of 1942. Under the Act, both long- and short-term capital losses could be deducted against both long-term and short-term gains, and against $1,000 of ordinary income. Net capital losses could be carried over for 5 years against future capital gains and $1,000 per year of ordinary income. The Act also introduced capital gains treatment for trade or business property.

Under the law existing at this time, taxpayers were effectively able to offset every dollar of net short-term capital loss against two dollars of net long-term capital gain. This resulted because, in computing net capital gain or loss, taxpayers excluded 50 percent of their net long-term capital gain, but included 100 percent of their net short-term capital loss. The Revenue Act of 1951 corrected this situation by providing that net short-term capital losses must first be offset against net long-term gains. One-half of the resulting excess of net long-term gain over net short-term loss was then excluded from income. This provision was adopted under the Internal Revenue Code of 1954.

The Revenue Act of 1964 amended the Code to provide an unlimited carryover of capital losses.

The Tax Reform Act of 1969 made several further adjustments to the treatment of capital losses and carryovers. First, the 1969 Act provided that only one-half of excess net long-term losses could be deducted against $1,000 of ordinary income. This prevented taxpayers from managing their investments so as take advantage of the 50-percent exclusion for long-term gains in one year but obtain a 100-percent deduction (to the extent of $1,000) in another year. The

1969 Act also limited married taxpayers filing separate returns to $500 of capital loss deductions against ordinary income.

The Tax Reform Act of 1976 increased the amount of ordinary income against which capital losses may be deducted to $2,000 in 1977 and $3,000 in 1978 and all subsequent years ($1,500 for married taxpayers filing separate returns). The Economic Recovery Tax Act of 1981 provided a 3-year capital loss carryback for losses in regulated futures contracts to offset prior gains from those contracts, in connection with the mark-to-market system of taxing such assets enacted in that bill.

Capital losses of corporation

Until the Revenue Act of 1934, capital losses of corporations were deductible in full against ordinary income. The 1934 Act provided that 100 percent of net long-term capital losses could be deducted against capital gains and up to $2,000 of ordinary income. The Revenue Act of 1939 removed this $2,000 limitation with respect to long-term capital losses, allowing such losses again to be fully deductible against ordinary income. In the case of short-term losses, the 1939 Act denied a deduction in the year of loss but allowed a carryover against short-term gains in the next succeeding year.

The Revenue Act of 1942 provided the first reduced taxation for corporate capital gains, in the form of an alternative maximum tax. Under the 1942 Act, no capital losses of corporations could be used to offset ordinary income. However, the Act allowed corporations (together with individuals) to carry forward net capital losses for a 5-year period. This rule remained in effect (subject to changes affecting both individual and corporate taxpayers) until the Tax Reform Act of 1969.

The Tax Reform Act of 1969 allowed excess net capital losses of corporations to be carried back to the 3 preceding taxable years as well as forward to each of the 5 succeeding taxable years. In each case, the loss carryback or carryover is to be treated as a short-term capital loss. The allowance of carrybacks has the effect of providing corporations with immediate refunds for excess losses and thus partially compensates corporations for being unable to deduct capital losses against ordinary income.

Analysis

Deductibility against ordinary income.—The present limits on the deductibility of capital losses against ordinary income are made necessary by the fact that taxpayers have discretion over when to sell assets. Thus, if capital losses were fully deductible against ordinary income, as was the case between 1921 and 1934, a taxpayer owning many assets could selectively sell only those assets with losses and thereby eliminate the tax on ordinary income even if those losses were offset by unrealized capital gains in the taxpayer's portfolio. However, limits on the deductibility of capital losses are unfair to taxpayers who have losses in excess of unrealized gains, since they may never get to deduct legitimate losses. The present system—allowing the deduction of losses against up to $3,000 of ordinary income—is a compromise between the desire to be fair to taxpayers with net losses and the need to protect the tax base. In effect, small investors, who are presumed not to have large portfolios with unrealized gains, are allowed to deduct capital losses against ordinary income; and large investors, for whom $3,000 is not significant, are not. Reducing the $3,000 limit would tilt the balance towards protecting the tax base and away from equity to small investors with net losses.

50-percent reduction of long-term losses.—The present rule requiring that long-term losses be reduced by 50 percent when deducted against ordinary income is also a compromise between the need to protect the tax base and equity to investors with net capital losses. If long-term losses were fully deductible against ordinary income, as was the case before 1969, taxpayers with both long-term gains and losses could realize the gains and losses in alternate years, paying tax on only 40 percent of the gains and fully deducting the losses. (A taxpayer who takes care to realize losses before they become long-term can, of course, achieve this result despite the 50-percent reduction.) The present system is unfair, however, to a taxpayer with nothing but long-term losses, because these are not fully deductible, and it was concern over this situation that caused Congress to retain a 50-percent cutback, instead of increasing it to 60 percent, when the capital gains exclusion percentage was increased from 50 to 60 percent in 1978.

When the 50-percent cutback of long-term capital losses deducted against ordinary income was enacted, a transitional rule was provided for taxpayers with pre-1970 losses. This rule complicates the capital gains tax forms, and now that taxpayers have had 14 years in which to deduct their pre-1970 losses, it may be appropriate to repeal the transition rule.

Tax-motivated transactions.—Finally, there are techniques for converting capital losses, deductible only against a limited amount of ordinary income, into fully deductible losses. Taxpayers accomplish this by selling stock short just before it pays a dividend. They get a short-term capital gain, against which they may deduct their otherwise-unusable capital loss, and an ordinary deduction for the payment they must make in lieu of a dividend. When a corporation pays an unusually large dividend, there is frequently significant short-sale activity. For example, Chrysler is about to pay four years of accumulated dividends on its preferred stock, and short interest amounts to 2.1 million shares (compared to 10 million shares of outstanding preferred stock). Treasury has proposed that Congress eliminate this transaction by requiring short-sellers to capitalize, not deduct, the payments they make in lieu of dividends to the person from whom they have borrowed the stock. Other tax-motivated transactions that convert capital losses into ordinary losses include contributing property with an unrealized loss to a broker-dealer partnership, for whom the loss would be an ordinary loss, combined with a special allocation of that loss to the taxpayer.

Revenue and distributions impact.—Table 2 shows the impact of reducing the limit on the amount of ordinary income against which capital losses can be deducted from $3,000 to $1,000 by income class at 1982 income levels. 1.2 million taxpayers would experience tax increases amounting to $490 million. 84 percent of the increase would go to taxpayers with incomes below $100,000, and 55 percent to taxpayers with incomes below $50,000. If made effective starting in 1984, the revenue gain would be negligible in fiscal year 1984, $594 million in 1985 and $588 million in 1986.

Table 2.—Reduce Capital Loss Limitation to $1,000

1982 Income Levels

[Returns in thousands, dollar aggregates in millions]

Expanded income [1] class	Tax decrease			Tax increase			Net tax change	Percent of total distribution
	Returns	Amount	Average	Returns	Amount	Average		
Under $10,000	0	0	0	125	$23	$186	$23	4.7
$10,000 to $20,000	0	0	0	209	52	251	52	10.7
$20,000 to $30,000	0	0	0	210	68	324	68	13.9
$30,000 to $40,000	0	0	0	184	71	388	71	14.6
$40,000 to $50,000	0	0	0	119	54	459	54	11.1
$50,000 to $75,000	0	0	0	182	98	537	98	20.7
$75,000 to $100,000	0	0	0	65	43	656	43	8.7
$100,000 to $200,000	0	0	0	76	57	751	57	11.7
$200,000 and over	0	0	0	27	23	839	23	4.6
Totals	0	0	0	1,198	490	409	490	100

[1] Expanded income equals adjusted gross income plus excluded capital gains and various other preference items less investment interest to the extent of investment income.

III. OPTION STRADDLES

A. Background

Description of certain domestic exchange-traded investment products

Futures contracts, stock options, and a number of other comparable investment products are traded on one or more domestic exchanges. In addition, foreign currency contracts which are economically comparable to futures contracts in foreign currency are traded in an informal interbank market.

Futures contracts.—A futures contract is a firm commitment to sell (a "short position") or to purchase (a "long position") a specified quantity and grade of a commodity (e.g., silver) during a designated month in the future. The obligation to make or accept delivery of the underlying commodity may be terminated by purchasing or selling an offsetting futures contract for the same delivery month prior to the time of actual delivery. U.S. commodity futures exchanges employ a daily cash settlement mark-to-market system to determine initial and variation margin requirements.[1]

Cash settlement futures contracts do not provide for the delivery of property, but call for cash settlement only based on the price movement in designated property, such as an index of stock prices (e.g., the Standard and Poor's 500-stock index).

Stock options.—A stock option is a contract under which the "writer" grants to the "holder" the right to purchase (a "call") or sell (a "put") the underlying stock for a specified price ("strike price") during the option period. The consideration ("premium") for option rights is paid at acquisition, and the holder has no further obligations under the option unless and until the option is exercised. To the extent the option's value, i.e., the premium for the option, increases or decreases, the grantor is required to deposit or is credited daily with additional amounts or may receive a credit with respect to amounts previously deposited. When the transaction is cleared through the clearing organization associated with the exchange, the clearing organization becomes the opposite party to each position, i.e., it becomes the writer to each holder and the holder to each writer. This corresponds to the similar mechanism employed in clearing futures contacts.

The rights of a holder or a writer of a stock option are terminated by (1) a closing transaction (an exchange mechanism involving the acquisition of an offsetting option with the same strike price and expiration date), (2) lapse of the option (i.e., expiration of the

[1] Initial margin is the amount each party must deposit to guarantee contract fulfillment at the time a futures position is established. Variation margin is the amount required to be deposited with a broker due to losses, or the amount that may be withdrawn in the case of gains, as the result of price changes with respect to a futures contract during the day.

option period without exercise), or (3) the exercise of the option. Upon exercise, the holder either purchases from or sells to the clearing organization at the strike price. The clearing organization in turn exercises its option as holder to purchase from or sell to a writer with an obligation identical to that performed by the clearing organization.

Currently, debt options (e.g., where the underlying property is a Treasury bill or bond) and currency options (where the underlying property is foreign currency) are traded in the same manner as stock options. The market mechanics of cash settlement options also parallel those of stock options, except that cash is received on exercise.

Commodity options.—A commodity option is a contract under which the writer grants to the holder the right to enter into a futures contract to sell (a "commodity put option") or to purchase (a "commodity call option") a designated commodity for future delivery at the strike price during the option period. Margin requirements applicable to writers, modes of termination, and the function of the clearing organization are the same for commodity options as for other options. However, a principal difference between commodity and other options is that, upon exercise, the holder of a commodity option does not acquire or dispose of the commodity involved but becomes a party to a futures contract with respect to the commodity. Margin deposits, which will have been paid by an option writer over the period the option was in existence, is credited to the holder at the time of exercise in order to mark his futures position, long if the option was a call or short if the option was a put, to market at such time.

Foreign currency (bank forward) contracts.—Trading in foreign currency for future delivery is conducted through contracts negotiated with one of a number of commerical banks comprising an informal market. Foreign currency contracts do not call for daily variation margin to reflect market changes, and there is no mechanism for terminating a party's position prior to the delivery date.

Straddles

The possibility that, absent specific statutory rules, certain transactions called spreads or straddles could afford taxpayers the opportunity to defer income and to convert ordinary income and short-term capital gain to long-term capital gain has been recognized by the investment industry for decades. In general, a straddle is constructed by taking offsetting positions with respect to property. For example, a straddle in futures contracts can be achieved by entering into a long position in one delivery month and a short position in another delivery month. The two positions, called "legs," are expected to move in opposite directions but with approximately equal absolute changes. Thus, for example, if one leg of a straddle increases $500 in value, the other leg can be expected to decrease in value by about the same amount. Absent specific statutory rules, the liquidation of the loss leg arguably could result in the realization of a $500 tax loss; further, realization of the gain in the other leg could be postponed by failing to liquidate the gain leg (but the gain could also be locked in by acquiring a new offsetting futures contract). By maintaining balanced positions, the risks of the transaction are minimized.[2] Margin requirements reflect the minimized risk involved in straddles. Straddles in stock options (and other exchange-traded investment products) parallel straddle transactions in futures contracts.

Options industry proposal

The Chicago Board Options Exchange, Inc. ("CBOE") has developed a legislative proposal that is intended to (1) restrict the ability of tax shelters to use stock options to defer income, and (2) provide a consistent Federal income tax regime for the taxation of options and futures contracts. CBOE's proposal is described in detail in subpart (C), below.

B. Present Law

The Internal Revenue Code contains specific rules to prevent deferral of income and to prevent conversion of ordinary income and short-term capital gain to long-term capital gain in straddle transactions involving exchange-traded investment products. Generally, the deduction of losses on straddle positions involving actively traded property (other than stock) is limited to the amount by which such losses exceed unrecognized gains on any offsetting straddle positions (the "loss deferral" rule). Gain and loss on regulated futures contracts ("RFCs") are reported under a mark-to-market rule that corresponds to the daily cash settlement system employed by U.S. commodity futures exchanges to determine margin requirements (the "mark-to-market" rule).

The loss deferral rule does not apply to stock or to domestic exchange-traded stock options with respect to which the maximum period during which such options may be exercised is less than the minimum holding period for long-term capital gain treatment. Because all domestic-exchange traded stock options have a maximum term of approximately nine months, and twelve months is the required holding period for long-term capital gain treatment, all such options are now exempt from the loss deferral rules. Further, the application of the mark-to-market rule to other types of exchange-traded options is unclear.

[2] The risk (i.e., potential for profit or loss) in a futures contract is that the price of the underlying commodity will rise or fall. In a straddle in futures contracts, the risk is that the spread or difference between the prices of the two legs will widen or narrow; the general trend of the price of the underlying commodity has no direct economic effect.

Taxation of options

In general, an option is considered to be an open transaction. The party that acquires the underlying property upon exercise of a call or put does not recognize gain or loss since the option and its exercise are together viewed as a purchase of the property. Both the holder of a call and the writer of a put treat the premium paid or received as an adustment to the purchase price of the underlying property. The party that sells the underlying property recognizes gain or loss. The holder of a put and the writer of a call treat the premium paid or received as a reduction or increase in the amount realized upon the sale of the underlying property.

Treatment of holders.—The premium paid for a call or a put is a nondeductible capital expenditure. Gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, a call or a put is considered gain or loss from the sale or exchange of property that has the same character as the property to which the option relates has, or would have, in the hands of the holder (sec. 1234(a)(1)). Thus, if the property to which the option relates would be a capital asset in the hands of the holder, capital gain or loss would result. Such capital gain or loss would be long-term or short-term depending upon the holding period of the option (sec. 1222).

If a call is exercised, its cost (i.e., the premium paid) is included in the cost basis of the property that the holder purchased. If a put is exercised, its cost reduces the amount realized upon the sale of the underlying property, in determining gain or loss. Such gain or loss is capital gain or loss and is short-term or long-term, depending on the character and the holding period of the underlying property.

Treatment of writers.—The premium received for writing a call or a put is not included in income at the time of receipt, but is deferred until (1) the writer engages in a closing transaction, (2) the option lapses, or (3) the writer sells or purchases the underlying property pursuant to the option.

If the writer enters into a closing transaction, gain or loss, generally reflecting changes in the value of the option and transaction costs, is short-term capital gain or loss (sec. 1234(b)(1)). If the option lapses, the premium is treated as a short-term capital gain to the writer. Section 1234, which provides for the treatment of gain or loss from a closing transaction and gain from a lapsed option, is stated to apply only to options to buy or sell property. It is unclear whether the cash settlement feature of certain options would prevent the option from being treated as an option to buy or sell property. Thus, the tax treatment of cash settlement options is unclear.

If a call is exercised, the premium received by the writer is included with the strike price in the amount realized, for purposes of determining gain or loss on the writer's sale of the underlying property. Such gain or loss is capital gain or loss and is short-term or long-term, depending on the character and holding period of the underlying property. If a put is exercised, the premium received by the writer reduces the cost basis of the underlying property. The period of time during which the writer of a put was obligated under the option is not tacked on to the holding period of the property acquired pursuant to the put.

Treatment of broker-dealers.—Gain or loss from transactions in options written or acquired in the ordinary course of a taxpayer's trade or business are treated as ordinary income or loss. Some taxpayers may write or acquire options in the ordinary course of their trade or business, and may write or acquire other options in connection with investment activities. In such cases, the general rules described above would apply to options written or acquired in connection with the taxpayer's investment activities. Generally, persons who are treated as writers of options in the ordinary course of their trade or business will be those who "make a market" with respect to a particular option or who engage in options transactions to hedge a position in the underlying security or commodity.

Application of short-sale rule.—In the case of a "short sale" (i.e., where the taxpayer sells borrowed property and later closes the sale by buying the identical property and returning the same to the lender), any gain or loss on the closing transaction is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer (sec. 1233(a)). The Code contains several rules that were intended to eliminate specific devices in which short sales could be used to transform short-term gains into long-term gains. Under these rules, if a taxpayer holds property for less than the long-term holding period and sells short substantially identical property, any gain upon the closing of the short sale is considered short-term gain, and the holding period of the substantially identical property is generally considered to begin on the date of the closing of the short sale (sec. 1233(b)). These rules are intended to preclude the taxpayer from "aging" his holding period so as to convert short-term capital gain into long-term capital gain where the taxpayer has materially reduced his risk of loss. However, the definition of "substantially identical property" is fairly narrow. Also, if a taxpayer has held property for more than one year and sells substantially identical property short, any loss on the closing of the short sale is considered long-term capital loss (sec. 1233(d)). This rule is intended to prevent the conversion of long-term capital loss into short-term capital loss.

For purposes of these rules, property includes stock, securities, and commodity futures (sec. 1233(e)(2)(A)), but commodity futures are not considered substantially identical if they call for delivery of the commodity in different calendar months (sec. 1233(e)(2)(B)). In addition, these rules do not apply in the case of hedging transactions in commodity futures (sec. 1233(g)).

The acquisition of a put is a short sale, and the exercise or failure to exercise such an option is considered as a closing of the short sale (sec. 1233(b)). If the put is acquired at a time when the underlying property has been held by the taxpayer for 12 months or less, or if the underlying property is acquired after acquisition of the put and before its termination, any gain on exercise or termination of the put is short-term capital gain. Further, the holding period of the underlying property is considered to begin on the earlier of (1) the date such property is disposed of pursuant to the put, or (2) the date the put is exercised, is sold, or expires, as the case may be.

However, if a put and the property identified to be used in its exercise are acquired on the same day, the acquisition of the put is not treated as a short sale (sec. 1233(c)). If the put is not exercised, the premium paid for the put is added to the cost basis of the identified property.

Application of wash-sale rule.—The wash-sale rule disallows any loss from the disposition of stock or securities where substantially identical stock or securities (or an option to acquire such property) are acquired by the taxpayer during the period beginning 30 days before the date of sale and ending 30 days after such date (sec. 1091). Commodity futures are not treated as stock or securities for purposes of this rule. Rev. Rul. 71-568, 1971-2 C.B. 312.

Loss deferral rule

In general, if a taxpayer realizes a loss on the disposition of one or more positions in a straddle, the amount of the loss that may be deducted is limited to the excess of the loss over the unrecognized gain (if any) in offsetting positions (sec. 1092(a)(1)). Deferred losses are carried forward to the succeeding year and are subject to the application of the loss deferral rule in that year. Deferred losses are recognized in the first year in which there is no unrecognized appreciation in offsetting positions. In addition, Treasury is authorized to prescribe regulations applying to straddles rules similar to certain provisions of the short-sale rule and the wash-sale rule (sec. 1092(b)). The loss deferral rule does not apply in the case of a "hedging transaction" (as defined for purposes of the mark-to-market rule discussed below) (sec. 1092(e)).

Definition of a straddle.—For purposes of the loss deferrral rule, a straddle is defined as offsetting positions with respect to personal property (other than stock) of a type that is actively traded (sec. 1092(c)). A position is an interest in personal property, including an option, a futures contract, or a forward contract (sec. 1092(d)(1)). A taxpayer is treated as holding a straddle if there is a substantial reduction in the taxpayer's risk of loss from holding any position in personal property because the taxpayer holds one or more other positions in personal property (regardless of whether the personal property is of the same kind). Taxpayers are presumed to hold offsetting positions in specified circumstances (e.g., if the aggregate margin requirement for two or more positions ordinarily is lower than the sum of the margin requirements for each of the positions when held separately).

Identified straddles.—Losses on straddle positions that a taxpayer identifies as such are not subject to the loss deferral rule (sec. 1092(a)(2)). The losses on positions in an identified straddle are treated as sustained not earlier than the day on which the taxpayer disposes of all the positions comprising such a straddle. To qualify as an identified straddle, all of the positions in the straddle must be acquired on the same day and the straddle must either have all its positions closed on the same day during the taxable year or have no positions closed by the end of the taxable year. An identified straddle must be clearly marked as such on the taxpayer's records before the close of the day it is acquired.

Mixed straddles.—A straddle composed entirely of regulated futures contracts (RFCs) is not subject to the loss deferral rule but is subject to the mark-to-market rule (sec. 1256(a)(4)). However, if a straddle is composed of both RFCs and positions that are not RFCs, then the straddle will be subject to the loss deferral rule (including the straddle rules relating to short sales and and wash sales). If the taxpayer designates the positions as a mixed straddle, the RFCs would be excluded from the mark-to-market rule. If the mixed straddle also qualifies as an identified straddle, not only would the RFCs be excluded from the mark-to-market rule, all the positions in the straddle would be excluded from the loss deferral rule. However, in either case, the straddle would remain subject to the straddle rules relating to short sales and wash sales.

Capitalization of certain interest and carrying charges.—Taxpayers are required to capitalize certain otherwise deductible expenditures for property that is held as part or all of an offsetting position, and for charges for the temporary use of property borrowed in connection with a short sale constituting part of a straddle (sec. 263(g)). Expenditures (or "carrying charges") subject to this requirement are interest on indebtedness incurred or continued to purchase or carry property, as well as amounts paid or incurred for temporary use of the property in a short sale, or for insuring, storing or transporting the property. The amount of carrying charges required to be capitalized is reduced by any interest income from the property (including original issue and acquisition discount), which is includible in gross income for the taxable year. The capitalization requirement does not apply to hedging transactions that are exempt from the loss deferral rule (sec. 263(g)(3)).

Mark-to-market rule

Each RFC held by a taxpayer at year-end is treated as if it were sold for its fair market value on the last business day of the year (sec. 1256(a)(1)). Ordinarily, the settlement price determined by an exchange for its RFCs on the year's last business day is considered to be the RFC's fair market value. Any gain or loss on the RFC is taken into account for the taxable year, together with the gain or loss on other RFCs that were closed out before the last business day. If a taxpayer holds RFCs at the beginning of a taxable year, any gain or loss subsequently realized on these contracts is adjusted to reflect any gain or loss taken into account with respect to the contracts in a prior year (sec. 1256 (a)(2)).

60/40 treatment.—Any gain or loss with respect to an RFC that is mark-to-market is treated as if 40 percent of the gain or loss is short-term capital gain or loss, and as if 60 percent is long-term gain or loss. This allocation of capital gain results in a maximum rate of tax of 32 percent for investors other than corporations.

Definition of an RFC.—An RFC is a contract that (1) is marked to market under a daily cash settlement system of the type used by U.S. futures exchanges to determine the amount that must be deposited due to losses, or the amount that may be withdrawn in the case of gains, as the result of price changes with respect to the contract during the day, and (2) is traded on or subject to the rules of a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, or any board of trade or exchange that Treasury determines operates under adequate mark-to-market rules (sec. 1256(b)). Cash settlement futures contracts are included in the definition of an RFC.

Certain foreign currency contracts are treated as RFCs (sec. 1256(b)(g)). For purposes of this rule, a foreign currency contract is defined as a contract that (1) requires delivery of a foreign currency that is also traded through RFC's, (2) is traded in the interbank market, and (3) is entered into at arm's length at a price determined by reference to the price in the interbank market.

Status of commodity options.—Under present law, the Federal income tax treatment of commodity options is unclear. The following specific issues have arisen: (1) whether commodity options constitute RFCs in the hands of holders and/or writers, (2) assuming that commodity options are not RFCs, whether the holder of a commodity option obtains 60/40 treatment upon disposition of the option, by virtue of the status of the underlying property, and (3) assuming that commodity options are not RFCs and that gain or loss to a holder on disposition is not accorded 60/40 treatment, whether a holder and/or writer can convert option gain to gain eligible for 60/40 treatment by entering into a RFC upon exercise of a commodity option.

Hedging exemption.—The mark-to-market rules do not apply to hedging transactions (sec. 1256(e)). A hedging transaction is an identified transaction that the taxpayer executes in the normal course of a trade or business primarily to reduce certain risks, and that results in only ordinary income or loss. To prevent manipulation of the hedging exemption by tax shelters, the exemption for hedging transactions does not apply to transactions entered into by syndicates. A syndicate is defined as any partnership or other entity (other than a subchapter C corporation) if more than 35 percent of the entity's losses during any period are allocable to limited partners or limited entrepreneurs.

C. Analysis

As indicated, present law does not provide clear guidance as to the tax treatment of commodity options and may provide inappropriate results as applied to other option transactions.[3]

Commodity options

In the case of commodity options, the holder, as in the case of other options, is required to pay a premium which reflects both (i) the difference, if any, between the option strike price and the current trading price of the RFC plus (ii) the time value of the option

[3] The analysis of present law reflected in the text does not take account of the possibility that losses incurred in straddle transactions may be disallowed under the rationale of Rev. Rul. 77-185, 1977-1 C.B. 48. That ruling held that a loss from certain silver futures contracts constituting part of a straddle was not deductible because the taxpayer "had no reasonable expectation of deriving an economic profit from the transactions." It was also held that the loss claimed on disposing of the loss leg of a straddle was not a loss from a closed and completed transaction. In addition, a loss incurred on disposing of the loss leg of a straddle consisting of silver futures positions was disallowed in *Smith* v. *Commissioner*, 78 T.C. 350 (1982) because the transaction, consisting of the entire straddle and the pre-planned sequence of trading, was not entered into for profit. The rationale of that case may result in loss disallowance in some cases.

Also, losses may be disallowed or gains may be treated as short-term (or losses as long-term) pursuant to regulations extending the wash sale and short sale rules to gain or loss with respect to positions of a straddle (sec. 1092(b)). The analysis in the text does not take into account the effect such rules, which have not yet been adopted, may have.

i.e., the additional risk assumed by the writer of the option). The holder's position is not thereafter adjusted until the option is terminated by offset, expiration of exercise. The writer, on the other hand, is required to make deposits on a daily basis if the value of the option increases and is correspondingly credited with decreases in the value. The writer of a commodity option is therefore governed by a system resembling the marking to market system applicable to RFCs while the holder is not.

Some contend that writers of commodity options, under present law, are holders of RFCs because they are parties to contracts traded on and regulated by domestic exchanges and are under a system of marking to market, thus satisfying the two elements in the definition of an RFC (sec. 1256(b)). Writers of commodity options, under this view, would have contracts open at the close of the taxable year marked to market for tax purposes and, if the contracts are capital assets, 60 percent of any gain or loss would be long-term and 40 percent short term. The staff does not believe that this result was intended by Congress in 1981; however, explicitly treated commodity options as RFCs may be appropriate policy.

Those espousing the view that commodity options are RFCs under present law concede that holders of commodity options are not parties to an RFC because they are not marked to market and, therefore, would be subject to tax only when their positions are terminated. However, present law provides that the character of gain or loss to an option holder upon sale, exchange or expiration of the option has the same character as the property to which the option relates would have in the hands of the taxpayer (sec. 1234(a)). It is contended that this rule requires 60/40 treatment to the holder of a commodity option, if the option is permitted to expire or is terminated by a closing transaction (i.e., if it is not exercised), because the property to which the option relates, a regulated futures contract, would have such treatment. The staff's *General Explanation of the Economic Recovery Tax Act of 1981* states that this argument does not reflect congressional intent in 1981; however, it may be appropriate to change the law to treat holders of commodity options the same as holders of RFCs.

A major difficulty with treating writers but not holders of commodity options as parties to an RFC would be the disparate treatment of the parties. Writers would be marked to market on their year-end open positions while holders would not. Writers would be required on exercise of an option to take into account any gain or loss attributable to the option period on a 60/40 basis. Option holders who acquire an RFC on exercise would not be subject to tax at that time. However, comparable treatment of holders and writers with respect to exercised options would be achieved if gain or loss attributable to the option period were merged into gain or loss attributable to the RFC acquired by a holder upon exercise, with an adjustment to exclude the option premium from such gain or loss. In such case all gain or loss (including that attributable to the option) would be subject to tax for the taxable year of exercise under the mark to market rules. The tax treatment applicable when a commodity option is exercised is discussed in more detail below.

A view of present law advanced by others would treat commodity options in the same manner as other options. When the holder terminates the option in a closing transaction or permits it to expire gain or loss would be short-term or long-term depending on whether the option has been held for more or less than 1 year (sec. 1234(a)). For writers, all gain or loss from expiration or a closing transaction would be short-term (sec. 1234(b)). This view results in applying the same treatment to commodity options under present law that applies to other options. However, a view also advanced by some would construe present law rules governing either writers or holders when a commodity option is exercised either to require recognition of gain or loss on exercise or to require continued deferral combined with separate accounting for such gain or loss. Separate accounting would be required to preclude 60/40 treatment since, under this view, only gain or loss attributable to the RFC, and not the option, would be subject to such treatment. This second interpretation would be needed to prevent some of the abuses that now exist, but it is not certain that it would be sustained by the courts.

Present law appears to preclude the recognition of gain or loss to the parties on acquiring property through exercising an option other than a commodity option. Generally on the exercise of an option, only the seller of the underlying property (i.e., the holder of a "put" or the writer of a "call") has immediate tax consequences. For the buyer of the underlying property (i.e., the writer of a "put" or the holder of a "call"), the option premium received or paid is taken into account as an adjustment to the basis of the property acquired. Gain or loss attributable to the option is taken into account only as gain or loss from the disposition of the property acquired through exercise of the option and the holding period for the property does not commence until the property is acquired pursuant to the exercise of the option.

Analogous results may be inappropriate on the exercise of a commodity option. Unlike the result when other options are exercised, the underlying property (i.e., the physical commodity) is not disposed of or acquired when the option is exercised. Instead the holder of a call or the writer of a put becomes, on exercise, the buying party in an RFC. Conversely, the writer of a call or the holder of a put becomes, on exercise, the selling party in an RFC. The holder of a call where the optioned property is, for example, an RFC requiring delivery of a commodity in June 1984, becomes on exercise both obligated and entitled to complete the purchase in June 1984 at the price fixed by the option agreement, the strike price. On exercise, the holder of a commodity option has a continuing right to make or take delivery for the option price but also becomes obligated to do so, while the writer has a continuing obligation to take or make delivery but also acquires the right to performance.

Although the taxpayer has a continuing contractual relationship with respect to the underlying property on exercise of a commodity option, gain or loss attributable to the option period can be readily ascertained at such time. The writer will have been required to provide, or will have been credited with, variation margin during the option period to the extent of market increases or decreases in the option period and will be required to make no payments beyond the option premium. While the holder will not be entitled to variation margin during the option period and will be required to make no payments beyond the option premium, upon exercise the holder will be credited with variation margin to the extent there have been price movements favorable to his position. For example, assume a $15 premium was paid for a put involving an RFC calling for June 1984 delivery of a commodity at a strike price of $125, the current trading price of the RFC, and that the option is exercised when the RFC has declined to $100. The writer will have paid in $25 in variation margin during the option period and, upon exercise, the holder will be credited with $25 of variation margin to reflect his position as holder of a short RFC entered at $125 (the option strike price) that is trading at $100. The holder has a $10 gain attributable to the option (the excess of the $25 of variation margin credited to his position over the $15 option premium) and the writer has a $10 loss attributable to the option (the excess of the variation margin paid in during the option period and credited to the holder on exercise over the option premium.[4] The provision of variation margin to the holder upon exercise merely marks to market at such time to the extent marking to market would have occurred if an RFC, rather than an option, had been originally acquired at the option strike price. As in the latter case, the taxpayer is in constructive receipt of the proceeds and has the same ability to pay tax on the gain.

The uncertainty under present law of the treatment of commodity options may result in taxpayers taking positions that are inconsistent. Those taxpayers with gains may claim that they are governed by the treatment applicable to RFCs in order that 60 percent of the gain will be long-term while those taxpayers with losses will claim they are covered by the rules applicable to other options and treat the loss as wholly short-term. The tax result sought may induce those with gains to exercise their options and become parties to RFCs contending that 60 percent of all gain on closing the RFC, including that attributable to the option, is long-term while those with losses will terminate their options through closing transactions or by permitting them to expire in order to claim short-term treatment. One possible solution to this problem would be to provide by statute that options on futures contracts be taxed like RFCs.

Present law continues to provide a special 6-month long-term holding period for gains and losses from futures transactions (sec. 1222) although 60/40 treatment is applicable to RFCs. One suggested construction of this rule, if exercise of a commodity option does not result in recognition, is that the portion of any gain or loss from the RFC attributable to the option period is to be treated as long-term, if the RFC is held by the taxpayer for 6 months. This conclusion is derived from application of the general rule that the holding period of an exercised option is not relevant in characterizing any gain or loss from the property acquired or disposed of in

[4] The mechanics of the transaction constitute an exercise by the holder of the put against the clearing organization, which in turn, as the holder of an equivalent put, exercises its option against the writer.

connection with the exercise as long-term or short-term, coupled with the conclusion that the option gain or loss is not derived from the RFC and is, therefore, not eligible for 60/40 treatment. It may be appropriate to consider whether the 6-month long-term holding period for futures contracts should be retained unless the holding period for other assets is also reduced to 6 months.

Cash settlement index options

The treatment of exchange traded options which settle only in cash is uncertain. The settlement price is determined by price movement based on a stock index or other designated property. Present law rules applicable to option holders apply to an option to buy or sell property (sec. 1234(a)) and the treatment applicable to a writer applies to an option in property (sec. 1234(b)). It is not clear that these rules result in capital gain or loss treatment for cash settlement options. Termination of rights or obligations with respect to personal property which would be a capital asset to the taxpayer results in capital gain or loss even though there is no sale or exchange (sec. 1234(A)). Cash settlement options may be subject to this rule but its application to these contracts is unclear.

Taxpayers with losses sustained on such contracts may claim ordinary loss treatment in view of the uncertain application of rules that would require capital loss treatment while taxpayers with gains presumably are claiming capital gain treatment.

The Technical Corrections Act of 1982 revised the definition of RFCs to include cash settlement futures contracts. Cash settlement options would receive more nearly comparable treatment to these contracts if they result in capital gain or loss rather than ordinary income or loss. Clarification of the rules of present law to provide explicitly for capital gain or loss treatment may be appropriate.

Stock option straddles

The exclusion of exchange-traded stock options from the loss deferral and other straddle rules results from the fact that currently these options have a maximum exercise period of 9 months, and only exchange-traded stock options with an exercise period exceeding the 1-year long-term capital gain holding period are subject to such rules. Straddles in stock options are being used to defer gains from one year to the next by realizing loss on an option that is matched by unrealized gain on an offsetting option carried into the following year.

Treasury Department representatives recently testified that stock options straddles have taken two forms.[5]

In one form, wealthy individuals become limited partners in a syndicate purporting to be a market maker in stock options. Losses realized in stock option straddles are passed through to such individuals as ordinary losses. Efforts to accomplish a similar result through the hedging exemption were precluded under ERTA for syndicates straddling in positions other than stock options (sec. 1256(e)(3)). Entities more than 35 percent of the losses of which are

[5] Statement of Robert G. Woodward, Acting Tax Legislative Counsel, before the Subcommittee on Oversight of the Internal Revenue Service, Senate Finance Committee, June 24, 1983.

allocated to limited partners are generally treated as syndicates in applying this rule.

In the other form, individual taxpayers seeking to shelter unrelated gain from current taxation enter a stock option straddle, typically composed of deep-in-the-money options. (An option is in the money if the strike price of a call is below the current value of the underlying property or if the strike price of a put is above the value of the underlying property.) This technique was illustrated by the following example included in the Treasury Department's testimony:

> Shares of T Corp. stock are trading at 75. On December 1, X buys (goes long) a T Corp. May 35 call option and simultaneously sells short a T Corp. May 40 call option. The premium required to be paid on the May 35 call is 41, while the premium to be received on the May 40 call is 36. T stock subsequently rises to 85. At the same time, the May 35 call increases in value from 41 to 51, and the May 40 call increases in value from 36 to 46. X closes out the May 40 call at a loss of 10 and immediately sells short a May 45 call, for 41. T stock does not change in value until year end. On January 2, X closes out the May 35 call at a profit of 10, and the May 45 call for no gain or loss. If, on the other hand, T stock had declined in value, X would have experienced a loss on the long May 35 call, and a corresponding gain on the short May 40 call with the result that the straddle loss would have been claimed on the long side. Thus, irrespective of the direction in which the market moved, X would have been able to produce a tax loss without material risk or cost (other than transaction costs).

A similar result can be achieved with offsetting options expiring in different months. A stock the price of which is expected to change substantially in a relatively short period is more likely to achieve the taxpayer's goal since a stable price will not generate the desired tax loss, although the taxpayer may be indifferent as to the direction in which the price moves. The technique is equally available to investors seeking to protect gain unrelated to stock option transactions from current taxation and to market makers and others seeking to shelter gains derived from stock option transactions.

Unidentified mixed straddles

Mixed straddles which the taxpayer does not identify may result in 60/40 gains (or losses) from the RFC leg of the straddle and offsetting losses (or gains) from the non-RFC leg which are all short-term or all long-term. Where the taxpayer also has unrelated gains or losses, RFC long-term gain or loss will be applied against correspondingly long-term loss or gain unrelated to the straddle rather than any short-term gain or loss derived from the non-RFC straddle leg. A similar matching applies to the RFC short-term gain or loss, if the unrelated gain or loss is short-term and the non-RFC gain or loss is long-term. The result may be to characterize a portion of the taxpayer's net gain or loss as short-term or long-term where it would not be so characterized if the straddle gains and losses were offset against each other and only the net straddle gain or loss, if any, were offset against unrelated gains or losses.

If a taxpayer, for example, has $100 of short-term gain unrelated to the straddle, $100 of long-term gain from the non-RFC straddle leg, and $100 of 60/40 loss on the RFC leg, $40 of the RFC loss (the short-term portion) will offset $40 of the unrelated short-term gain, leaving $40 of the gain from the non-RFC straddle leg to be taxed as long-term gain. If only a net straddle loss were used to offset unrelated gain, the $100 of unrelated gain would be fully taxed as short-term gain. The result in this example is favorable to the taxpayer if straddle gains and losses do not fully offset each other whereas, if the unrelated gain were long-term and the non-RFC leg of the straddle resulted in short-term gain, the net result would be $60 of short-term gain and $40 of long-term gain, a result unfavorable to the taxpayer compared with leaving the unrelated gain unaffected by straddle gains and losses.

Similarly, net losses can be characterized as short-term or long-term where such characterization would not result if mixed straddle gains and losses were required to offset each other before being applied to unrelated losses.

One of the proposals suggested by the CBOE would require full offsetting of gains and losses from an unidentified mixed straddle. Any net gain or loss from the RFC leg that remained after such offsetting would obtain 60/40 treatment. Any net gain derived from the non-RFC leg, after offsetting, would be short-term unless the non-RFC leg had been held for the long-term holding period at the time the taxpayer entered the mixed straddle. If a mixed straddle net loss, after offsetting, is derived from the non-RFC leg, it would be treated as short-term unless the non-RFC leg has been held for the long-term holding period when the mixed straddle was entered into, in which case the loss would be treated as long-term. These suggested results would leave gains or losses unrelated to the mixed straddle unaffected except to the extent of the net straddle gain or loss.

Rules which would produce appropriate results where the taxpayer has gains and losses from unidentified mixed straddles may be developed by regulations under present law, including those to be promulgated under sec. 1092(b) to adapt wash sale and short sale rules to straddle gains and losses. Problems incident to potential conversion of long-term or short-term gains or losses through the interaction of 60/40 gains and losses with unrelated gains and losses as a result of transactions in mixed straddles would be exacerbated by providing 60/40 treatment for exchange traded stock options since the underlying property (stock) would not be subject to the 60/40 rule.

CBOE proposal

As indicated, options generally are not subject to the mark-to-market and 60/40 rules applicable to RFCs although some contend that those rules may apply to writers of commodity options and that 60/40 treatment may apply to holders of such options. It is not clear how gain or loss attributable to a commodity option is to be treated if the option is exercised. It is likely that taxpayers with gains and losses are taking inconsistent positions which minimize their taxes as a result of the lack of clarity in the application of present law to commodity options. The character of gain or loss derived from cash settlement options is also unclear. Because of the exclusion of stock options from the straddle limitations under present law, investors and dealers may use stock options, particularly deep-in-the-money-options, to shelter gains from current taxation in the same manner as commodity futures were exploited prior to ERTA, and syndicates have attempted to exploit the exemption for stock options to pass through ordinary losses to limited partners. However, the Internal Revenue Service has challenged the claimed result under many of these transactions under the rationale of Rev. Rul. 77-185 and other theories. Mixed straddles which the taxpayer does not identify may result in reclassifying unrelated short-term or long-term or loss as a result of applying 60/40 treatment to the RFC portion of the straddle, unless the IRS precludes this result through regulations. This result, or the regulatory rules to prevent the result, would be applicable in many more cases if 60/40 treatment were extended to options.

Also, CBOE is concerned that 60/40 treatment of RFCs encourages investors to participate in those markets rather than in the options market. Even though both the options and futures markets are zero-sum games (i.e., for every winner there is an equivalent loser), investors presumably expect to win and, therefore, prefer 60/40 treatment. In some cases (e.g., stock index futures and options on stock index futures) similar instruments are traded on options and futures markets, and a taxpayer's choice of which market to participate in could be affected by tax considerations.

The CBOE has proposed a comprehensive revision of the treatment of options that, it believes, would deal with these problems.

Election of RFC treatment.—Under the proposal, all exchange-traded options would be brought within the RFC definition and become subject to mark-to-market and 60/40 treatment. However, this treatment would be elective under the proposal. The proposal would not apply to options to acquire stock from the issuer (warrants).

The status of a dealer in options would be equated with that of commodity futures traders. Such traders are subject to mark-to-market and 60/40 treatment regardless of the scope of their trading activities. As in the case of other RFCs, options would be excluded from the mark-to-market, 60/40, and other straddle rules only if they qualify for such exclusion under the hedging exemption of present law (sec. 1256(c)).

The taxpayer would have to qualify as a dealer in the underlying property independently of acquisitions or activity arising out of transactions in options in order to receive ordinary income or loss treatment with respect to such property. However, the proposal would preserve the exclusion from the wash-sale loss disallowance requirement (sec. 1091) for stock and securities disposed of by a dealer in options, to the extent such a dealer qualifies for the exclusion presently.

Exercise of an option would constitute an event resulting in recognition of gain or loss, as well as lapse of the option or a closing transaction.

The proposal would provide that an RFC option loss during the first three years after enactment of the proposal could be carried back against option gains to offset pre-election option gains that would have received short-term capital gain or ordinary income treatment under present law. Such gains would be converted to 60/40 treatment in applying the carryback. Present law (sec. 1212(c)) provides that RFC losses may be carried back for three years to offset RFC gains.

The proposal suggests that a pay-in period be provided for the tax incurred by an electing taxpayer attributable to option trading gains that have been deferred under present law. Sec. 509 of ERTA provided for elective installment payments (over a period not to exceed 5 years) of 1981 tax liability attributable to deferred RFC gains accrued prior to 1981.

Treatment of nonelecting taxpayers.—The CBOE proposal would apply the loss deferral rule to all exchange-traded options, including stock options, written or purchased by a nonelecting taxpayer. The loss deferral rule would also apply to stock (or a short position in stock), to the extent offset by an option. However, the CBOE proposal would provide an exception from the definition of offsetting positions for stock or securities and a short call that is not deep in the money (or for a short sale of stock or securities and a short put that is not deep in the money). Under the proposed exception, the loss deferral rule would not apply where the strike price of a covered call is at least 85 percent of the market value of the underlying stock or security (or where the market value of stock or securities sold short is at least 85 percent of the strike price of the put).

The present-law treatment of nonelecting options dealers would be retained. Thus, such an options dealer would continue to realize ordinary income or loss on options written or acquired in the ordinary course of his trade or business.

Cash settlement options.—The CBOE proposes to amend section 1234 to clarify that gain or loss with respect to the writer or holder of a cash settlement option is short-term capital gain or loss. Gain or loss with respect to cash settlement options written or acquired in the ordinary course of a dealer's trade or business would be ordinary income or loss.

Commodity options.—Under the CBOE proposal, the exercise of a commodity option would constitute a recognition event. Any gain or loss with respect to commodity options would be short-term in nature. These rules are intended to prevent the conversion of short-term capital gain with respect to the commodity option to gain eligible for 60/40 treatment.

Capitalization of dividends.—The CBOE proposal would include dividends and other amounts in the list of items that must be capitalized under section 263(g).

Mixed straddles.—CBOE proposal with respect to mixed straddles has been described above. The elective extension of RFC treatment to options and the inclusion of stock and stock options within the loss limitation and other straddle rules would expand the number of mixed straddles.

Comments on CBOE proposal

The clarification of gain and loss from cash settlement options as capital gain and loss and the treatment of the exercise of commodity options as an event requiring recognition of gain or loss may be considered as appropriate revisions of present law without regard to the balance of the CBOE proposals. If the extension of mark to market, 60/40 treatment is not extended to options, it may be advisable to clarify that writers of commodity options are not subject to such rules. However, without a mark-to-market system, making exercise of an option other than a commodity option a recognition event would represent a fundamental change in the tax treatment of options and, very likely, would be controversial.

Application of the mark to market and 60/40 rules to RFCs and foreign currency contracts under present law is not on an elective basis. If extension of such rules to options is appropriate, consideration should be given to making such treatment mandatory. However, a mandatory mark-to-market system for assets where there is no variation margin could involve imposing tax liability on taxpayers who do not have the cash to pay the tax (especially if the option is exercised). Conceivably, there could be a constitutional issue regarding taxation of unrealized income, although the staff does not believe that such a law would be unconstitutional.

The CBOE appears to have a legitimate concern about its competitive position *vis a vis* the futures markets owing to the fact that RFCs get 60/40 treatment and commodity options do not. However, some have argued that the CBOE proposal would simply shift the competitive imbalance, not eliminate it. The availability of 60/40 treatment for stock options, for example, may cause investors to shift their activity from the stock market to the options market.

Also, concern has been expressed about the extension of the tax preference resulting from 60/40 treatment to another category of assets. In response, the CBOE argues that options deserve parity with RFCs and that, since options are a zero-sum game, 60/40 treatment would not involve a revenue loss in the aggregate. However, it can be argued, in response to the CBOE argument, that aggregate revenue neutrality has little to do with tax equity since equity requires that winners pay full tax on their gains and losers get full deductions for their losses.

Finally, there is a question of whether an exception is appropriate for covered calls (i.e., calls written against a position in the underlying stock). While many taxpayers write covered calls for nontax reasons, other straddle rules do not contain similar exceptions. Also, the proposed 15-percent rule for defining a deep-in-the money call would include calls where there was little risk to the writer. A tighter definition would be appropriate. The Securities Industries Association has suggested that an exception for covered calls apply to calls whose strike price is at or above the strike price next below the closing price of the stock on the previous day. For example, if strike prices are at $5 intervals, and a stock sells for $58, the exception would apply to calls with a strike price of $55 or higher.

Treatment of stock options with a 6-month holding period

The exclusion of stock options from straddle limitation rules under present law applies to an option the exercise period of which is less than the long-term gain holding period. Because listed stock options have exercise periods less than one year, they are all presently exempt from the loss limitation rules. However, if the holding period were reduced to 6 months, stock options would no longer be exempt and, if stock options were exempted, it would be possible to use stock option straddles not only to defer tax but also to convert short-term capital gains into long-term gains. To address these problems, both H.R. 2225 and S. 13—the bills introduced by Cong. Anthony and Sen. Dole reducing the holding period to 6 months—provide an exemption from the loss deferral rule for stock options, but one that would not apply if a stock option were part of a straddle any position of which could produce long-term capital gain to the taxpayer if disposed of prior to the expiration of the option. The exemption would also be inappplicable to a straddle held by a syndicate (as defined in sec. 1256(e)) if a disposition results in ordinary income of loss. Finally, the exemption would be unavailable for ordinary losses of a dealer in options unless the option was entered into in the normal course of the dealer's trade or business.

While H.R. 2225 and S. 13 address the problem of syndicates seeking ordinary loss treatment for investors through option trading and also address the problem of market makers seeking to shelter gains from option trading from current taxation, they do not deal with other sheltering activities through the stock option exemption, such as offsetting positions in deep-in-the-money options.

Treasury proposal

In its Senate testimony, the Treasury suggested repealing the exemption for stock options from the loss limitation rules, including straddles between stock and stock options. This recommendation was intended to eliminate the use of straddles including stock options to defer tax.

The CBOE has criticized the Treasury proposal on the grounds that, particularly for market-makers who engage in thousands of transactions per year, it would be difficult to determine precisely which positions offset which other positions for purposes of applying the loss deferral and other loss limitation rules. The CBOE argues that a mark-to-market system would be more workable. However, many of the complexities of a loss deferral rule would be present under a mark-to-market rule as long as taxpayers engage in mixed straddles.

IV. CANADIAN PROPOSAL FOR TAXATION OF CAPITAL GAINS ON STOCK

Description

The Canadian Government, in its budget of April 1983, proposed an elective indexation program for Canadian securities, known as the Indexed Security Investment Plan (ISIP).[6] The plan would be limited to publicly listed common stock of Canadian corporations.

Under the Canadian plan, the basis of stock purchased under an ISIP would be adjusted each month according to the percentage increase in the consumer price index. At the end of each year, the investor would be required to recognize 25 percent of the real increase in value of the investment (i.e., after adjusting for the inflation rate) over the course of the year. The remaining 75 percent of increased value would be deferred until the succeeding year, to be taxed (together with any real increase in value during the succeeding year) under the same formula (i.e., 25 percent of the 75 percent would be recognized in the succeeding year). (Under the general Canadian capital gains rules, 50 percent of this recognized amount would then be included in income.) Any remaining untaxed increase in value would be taxed on disposition of the investment. The plan generally would treat losses in the same manner as capital gains. Losses from stocks put into an ISIP would be deductible against ordinary income without any dollar limit, although only 50 percent of such losses would be deductible and the loss deductions would be spread under the same 25-percent declining balance formula as are gains.

Investors would be allowed to transfer presently held securities to an ISIP. However, these securities would be indexed only for inflation occurring after 1983.

The Canadian Government plans to deny an interest deduction on funds borrowed to finance ISIP investments.

Analysis

The Canadian system provides an ingenious solution to some of the problems posed by the present U.S. method of taxing capital gains and losses. Stocks put into an ISIP would be taxed, with respect to both gains and losses, without regard to when the assets were sold, thereby eliminating the lock-in effect and year-end tax-loss selling. Also, since losses would be deductible against ordinary income without a dollar limit, the unfairness of the present U.S. system towards taxpayers with large net losses would be reduced. Finally the taxation of purely inflationary gains would be eliminated by indexing, which is simpler under a mark-to-market system

[6] Budget Speech, delivered in the House of Commons by the Honorable Marc Lalonde, Minister of Finance, April 19, 1983.

(such as the ISIP) than under a realization system (such as U.S. law).

The problem with a mark-to-market, or accrual, system of capital gains is that it may require taxing people when they do not have the cash to pay the tax, since they have not yet sold the asset. The Canadian proposal tries to deal with this problem by taxing only 12½ percent of the accrued gain in the first year. In the United States, mark-to-market treatment is generally provided only when taxpayers have variation margin accounts which they can use to pay the tax.

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