MEMO# 13153

February 13, 2001

IRS ISSUES PROPOSED REGULATIONS ON TREATMENT OF EQUITY CALL OPTIONS WITH FLEXIBLE TERMS UNDER TAX STRADDLE RULES

[13153] February 13, 2001 TO: TAX COMMITTEE No. 5-01 RE: IRS ISSUES PROPOSED REGULATIONS ON TREATMENT OF EQUITY CALL OPTIONS WITH FLEXIBLE TERMS UNDER TAX STRADDLE RULES In the attached regulations (Treas. Reg. 1.1092(c)-1; 1.1092(c)-2; 1.1092(c)-3), the Internal Revenue Service ("IRS") proposes to treat certain equity options with flexible terms ("FLEX options") and certain over-the-counter options ("OTC options") as "qualified covered call" ("QCC") options that are exempt from the tax straddle rules. The IRS also proposes to apply a one-year term limit to standardized equity options under the QCC rules. The regulations would apply prospectively to FLEX options and OTC options entered into on or after 30 days from the issuance of the regulations in final form. Time limits for equity options with standardized terms would apply prospectively to transactions entered into on or after 90 days from the issuance of the regulations in final form. Tax Straddles and Qualified Covered Call Options Section 1092(c) defines a tax straddle as offsetting positions with respect to personal property. Positions are offsetting when there is a substantial diminution of risk of loss from holding one position by reason of holding another position. Special rules are provided for the treatment of stock positions under the straddle rules. Among other adverse tax consequences of holding a tax straddle, realized losses on one position in a straddle must be deferred to the extent there is unrealized gain in any other position in the straddle. Under section 1092(c)(4), writing a qualified covered call or "QCC" option and owning the optioned stock is not a tax straddle if certain conditions are satisfied. Congress excepted QCC options from the loss deferral rule for straddles because they are undertaken primarily to enhance the taxpayer's investment return on the underlying stock (and not to reduce the taxpayer's risk of loss on the stock). To qualify as a QCC option, a covered call generally must be exchange-traded and not "deep in the money." For this purpose, an option is "deep in the money" if the strike price of the option is lower than the lowest qualified benchmark for the stock at the time the option is written. When section 1092(c)(4) was enacted, equity options traded on national exchanges had standardized terms, including strike prices at fixed intervals (such as in increments of $5) and 2fixed expiration dates of less than one year. These fixed terms provided the basis for the bench- mark system under section 1092(c)(4). FLEX Options, OTC Options and Longer-Term Standardized Equity Options FLEX options, unlike equity options with standardized terms, can have strike prices at other than fixed intervals and have other than standardized expiration dates.1 Notwithstanding these differences, however, FLEX options would be eligible for QCC treatment under the proposed regulations if: (1) the FLEX

options satisfied the general rules for QCC treatment under section 1092(c)(4) and had a term of one year or less and (2) an equity option with standardized terms was outstanding for the underlying equity. The “deep in the money” benchmarks for FLEX options would be the same as those for standardized equity options on the same stock having the same applicable stock price. The proposed regulations would treat an OTC option as eligible for QCC treatment if it was entered into with a person registered with the SEC as a broker-dealer or an alternative trading system and met the same terms for QCC treatment that applied to FLEX options. In recognition of offerings of standardized equity options on national securities exchanges with terms of a year or more, the regulations also propose that a one-year term limit apply to these contracts for purposes of the QCC rules. Absent such a term limit, and as explained by the preamble to the proposed regulations, a taxpayer entering into a standardized equity option potentially could achieve greater levels of risk reduction on the optioned stock than originally was intended under the QCC rules. The IRS requests comments on this issue, including the appropriateness of a one-year cutoff. The IRS also requests comments on whether it may be appropriate to change the “deep-in-the-money” standard to accommodate all types of longer-term equity options. ACTION REQUESTED: If there are comments that the Institute should submit to the IRS on the proposed regulations, please provide them to the undersigned no later than Friday, March 30, 2001 by e-mail (dflores@ici.org) or facsimile (202/326-5841). Deanna J. Flores Associate Counsel Attachment Attachment (in .pdf format) 1 In Treas. Reg. 1.1092(c)-1(b), the IRS clarified that strike prices for FLEX options do not affect the determination of the “lowest qualified benchmark” for equity options with standardized terms.