

is likely to be "put" to the writer. While in the great majority of the cases, one component of the straddle is exercised and the other is allowed to lapse, occasionally (perhaps 10 to 15 percent of the time) neither option is exercised and in a few other cases (less than 1 percent of the cases) both components of the straddle are exercised.

Although options are purchased for hedging and other similar purposes by some investors, their primary use probably is as a method of investing by individuals with small amounts of money.

b. Present law.—Under the 1939 code, premium income received from the writing of an option which had lapsed was treated as a short-term capital gain (sec. 117(g)(2) of the 1939 code). However, until the issuance of a revenue ruling in 1965 (Revenue Ruling 65-31) straddle writers generally allocated the entire straddle premium to the component option which was exercised, and this practice apparently was not challenged by the Internal Revenue Service prior to the issuance of the ruling. Since one component or the other of a straddle is exercised in the bulk of the cases, the fact that the premium in the case of the lapse of an option was treated as short-term capital gain was of relatively little significance. The important aspect was the treatment of the premium in connection with the portion of the straddle which was exercised.

If all of the premium is allocated to the component which is exercised and this is the "put," the premium decreases the cost or basis of the stock put to the writer of the straddle. As a result, it would increase his capital gain only when he disposed of the stock put to him. Generally, this would result in a long-term capital gain (unless he held the stock for less than 6 months). Where the call component is exercised and all of the straddle premium is allocated to it, the premium would increase the income received by the writer at the time the stock is called from (i.e., sold by) him. As a result in this case also, the total premium increases the writer's capital gain (or decreases his capital loss) and if the writer had held the stock for more than 6 months, the gain (or loss) would be long term.

The 1939 code provision treating income from the lapse of an option as a short-term capital gain was not included in the 1954 code. As a result, where both options are permitted to lapse, the total straddle premium is now reported as ordinary income. However, in the usual case where one option lapsed and the other was exercised, the treatment of allocating the straddle premium income to the side exercised in practice remained unchanged.

In the ruling (Revenue Ruling 65-31) issued on January 22, 1965, the Internal Revenue Service held that the premium for a straddle must be allocated between its put and call components on the basis of the relative market values of each. In a later technical information release, the Service announced that it would accept allocations of 55 percent of each straddle premium to the call component and 45 percent to the put component.²

² Rev. Proc. 65-29, issued on Nov. 15, 1965. This 55-45 ratio was selected because it represented a rounded approximation of relative market prices of separately written "puts" and "calls" of the same length for securities of approximately equal price. The revenue procedure concluded with the statement that "If a taxpayer does not use this method for a taxable year, then the allocation based on relative market values required by Revenue Ruling 65-31 must be used."