

Under the ruling, part of the premium arising from the writing of a single straddle can result in ordinary income (the portion of the premium allocated to the lapsed component) while the remaining portion of the premium may result in either a capital gain or a capital loss, which in the usual case will be a long-term gain or loss.

c. Reasons for the changes.—The difficulty with the present tax treatment of premium income from the writing of straddles lies in the fact that by dividing the premium income into two parts, one part may be reported as ordinary income (the portion allocated to the lapsed option) while the other portion may merely decrease a capital loss. Your committee believes that it is hard to justify treating part of the transaction as resulting in ordinary income, while the other portion may give rise to a capital loss which cannot be offset (apart from the \$1,000 per year deduction of net capital losses against ordinary income) against ordinary income.

The problem can be illustrated by the following example. Assume that a straddle writer issues a straddle for a stock when its price is \$100 a share and this is the option price. Assume that the straddle premium is \$8 per share. Assume further that the put component of the straddle is exercised by the purchaser when the price of the stock is \$80 per share. As a result, the writer of the straddle must buy stock at a price of \$100 per share when its market value is \$80 per share. If the straddle premium allocable to the put component is \$3.60 per share, the short-term capital loss for the writer of the straddle will be \$16.40 per share if he disposes of the stock shortly after receipt, when the market price is still \$80 per share. At the same time, the remainder of the straddle premium, \$4.40 a share, is allocated to the call component, which in such a case presumably was allowed to lapse. The \$4.40 per share would be ordinary income while the capital loss of \$16.40 a share attributable to the put side of the option would result in a short-term capital loss, which, except to the extent of the \$1,000 a year, could not be netted with the ordinary income attributable to the premium income of the other side of the straddle.

The writer of the straddle in these cases is, of course, entering the transaction in the hope of obtaining a profit; he naturally views the transaction as a single one and cannot see why he must pay ordinary income tax on a portion of the transaction while being denied full use of his capital loss attributable to the other component of the transaction (in those cases where he does not have capital gains sufficient to offset his capital losses and his losses exceed the \$1,000 which may be offset against ordinary income). Moreover, the marketplace treats the straddle as a single transaction in that a smaller premium is paid for a straddle than for a separate put and call on the same stock, since the combined risk involved is less. Additionally, the writer of the straddle knows that in almost all cases, only one of the two options in the straddle will be exercised. He views this as the side for which he is being paid the premium.

Your committee agrees that it is desirable to provide for this netting of a gain or loss arising from the two components of a straddle option. Nevertheless, it appears appropriate where the transaction on a net basis results in a gain, that the premium income result in ordinary income. The netting of the two components in a straddle can be