

granted to brokers or dealers who, in turn, customarily sell the put and call components to different purchasers. The majority of puts and calls originate in straddles. While the use of puts and calls is not a new development in the securities markets, their significance is relatively limited; for example, the total number of shares covered by options sold in recent years on the New York Stock Exchange has rarely exceeded 1 percent of the total shares sold.

Normally either (not both) the put or the call component of the straddle is exercised by the purchaser shortly before the end of the term for which the straddle is written. Frequently this is 6 months and 10 days after the straddle is issued. Which component of the straddle is exercised depends upon the market conditions at the time of exercise vis-a-vis market conditions at the time the straddle was written. If the market in that security has risen, the securities are likely to be "called" from the writer; if the market has fallen, the stock 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.

*Prior law.*—Under the 1939 code, premium income received from the writing of an option which lapsed without either the put or call being exercised was treated as a short-term capital gain (sec. 117(g) (2) of the 1939 code). When one component of the straddle was exercised, however, straddle writers generally allocated the entire straddle premium to the component option which was exercised. This practice apparently was not challenged by the Internal Revenue Service prior to the issuance of a revenue ruling in 1965 (Revenue Ruling 65-31). 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.

When 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 increases his capital gain only when he disposes of the stock put to him. Generally, this results in a long-term capital gain (unless he holds 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 increases the income received by the writer at the time the stock is called from (i.e., sold by) him. As a result in this cases also, the total premium increases the writer's capital gain (or decreases his capital loss) and if the writer has held the stock for more than 6 months, the gain (or loss) is 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 were permitted to lapse, the total straddle premium was reported as ordinary income. However, in the usual case where one option lapsed and the other was exercised, the practice