of allocating the straddle premium income to the side exercised was continued.

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.[7]

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

The manner in which prior law was applied under the ruling can be illustrated by the following example. Assume that a straddle writer issued a straddle for a stock when its price was $100 a share and this was the option price. Assume that the straddle premium was $8 per share. Assume further that the put component of the straddle was exercised by the purchaser when the price of the stock was $80 per share. As a result, the writer of the straddle had to buy stock at a price of $100 per share when its market value was $80 per share. If the straddle premium allocable to the put component was $3.60 per share, the short-term capital loss for the writer of the straddle was $16.40 per share if he disposed of the stock shortly after receipt, when the market price was still $80 per share. At the same time, the remainder of the straddle premium, $4.40 a share, was allocated to the call component, which in such a case presumably was allowed to lapse. The $4.40 per share was ordinary income while the capital loss of $16.40 a share attributable to the put side of the option resulted 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.

Explanation of provision.—The amendment adds a new subsection (c) to section 1234 of the code which provides that gain derived from the lapse of an option written as a part of a straddle (as defined in new section 1234(c)(3)) is, in effect, to be short-term capital gain. Thus, such gains will be added to any other short-term capital gains, to be netted against short-term capital losses, with the excess to be netted against any net long-term capital losses. Any remaining short-term capital gains will generally be taxed as ordinary income. This provision does not apply to a person who holds securities (including options to acquire or sell securities) for sale to customers in the ordinary course of his trade or business.

The new subsection defines a "straddle" as a simultaneously granted combination of an option to buy (a "call") and an option to sell (a

[7] 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."