

STAFF REPORT ON INCOME TAX TREATMENT OF INCOME RESULTING FROM LAPSE OF OPTIONS WRITTEN AS PARTS OF STRADDLES

PART ONE—INTRODUCTION

A "straddle" is a combination of an option to buy (a "call") and an option to sell (a "put") a specified amount of a certain security at a fixed price for a stated period of time.

In a ruling (Rev. Rul. 65-31) issued on January 22, 1965, the Internal Revenue Service held that the premium for a straddle must be allocated between its component parts on the basis of relative market values. Under the ruling, the portion of the premium received by the writer (the person who grants the options) for the component that is exercised is to be taken into account by him as a reduction in his basis for the security purchased ("put" to the option writer) or as a part of the amount realized on the security sold ("called" from him). As a result, this portion of the premium can either increase the capital gain or decrease the capital loss realized upon the sale or exchange of the security.¹ This can be either a long- or short-term gain or loss depending upon the period of time the security was held. Under the revenue ruling, the remaining portion of the premium, attributable to the expired component of the straddle, constitutes ordinary income. This ruling, which applied prospectively only, to straddle transactions entered into on or after January 26, 1965, is set forth as appendix I to this report.

In a technical information release (TIR-778) issued on November 15, 1965, the Internal Revenue Service determined that in the case of straddle contracts involving corporate stock, 55 percent of the premium may be allocated to the "call" and 45 percent to the "put."² However, if this allocation is used, it must be used by the taxpayer in allocating premiums on all straddle contracts issued on or after January 26, 1965.³ Those who do so must attach a statement to their Federal income tax returns so indicating. This release is set forth as appendix II to this report.

On January 27, 1965, Congressman Wilbur D. Mills, chairman, and Senator Harry F. Byrd, vice chairman, of the Joint Committee on Internal Revenue Taxation, instructed the staff of the joint committee to study any problems raised with respect to the January ruling on straddles and to present comments and suggestions to the committee with respect to it. The public announcement of these instructions is

¹ If the taxpayer is a dealer in securities, the gain will be an ordinary gain unless the provisions of section 1236 of the code are complied with. See section 1236(b) for treatment of losses.

² The Internal Revenue Service indicated that since the market values of "puts" and "calls" are subject to price fluctuations, it may be necessary for the Service to adjust this allocation ratio periodically.

³ Although TIR-778 is not clear on this point, it seems that this election is to be made for 1 taxable year at a time.