It is clear that, although options have a number of possible uses by sophisticated investors, they are in fact used primarily as a method of investing by individuals with small amounts of money.[16]

Before 1954, income from the writing of an option that lapsed was treated as short-term capital gain. The statutory provision (sec. 117(g)(2) of the 1939 Code)[17] requiring such treatment was not included in the 1954 Code.[18]

It is understood that, before 1954, however, straddle writers generally allocated the entire straddle premium to the component option that was exercised. This meant that, in practice, the gain from the lapse of one option in a straddle was often treated as long-term capital gain and many times was not recognized until a later taxable year.

In the case of "calls," the total straddle premium was treated as increasing the amount received by the writer when the stock was called from, i.e., sold by, him (and the "put" was allowed to lapse). The total premium thereby increased his capital gain (or decreased his capital loss, depending upon the circumstances of the individual case). If the writer had held the stock more than 6 months, the gain (or loss) would be long-term.

When the "put" was exercised (and the "call" was allowed to lapse), the total straddle premium was treated as reducing the basis of the stock put to (i.e., sold to) the writer. He could transform the total straddle premium into long-term capital gain by holding the stock for more than 6 months. If he sold the stock after the end of the taxable year, he could thereby postpone taxation of the entire straddle premium.[19]

This practice of allocating the entire premium to the option that was exercised apparently was not then challenged by the Internal Revenue Service.

It is understood that from 1954 until the issuance of Rev. Rul. 65–31, straddle writers continued to allocate the entire premium to the side of the straddle that was exercised.[20] The practical effect of this was to continue essentially the same treatment for straddles under the 1954 Code up to 1964 as existed in practice under the 1939 Code.[21]

It should be noted that prior to the issuance of Rev. Rul. 65–31, neither the statute nor the regulations or rulings indicated whether the premium for a straddle should be allocated between the two options or allocated entirely to the option which was exercised. As has been indicated, however, writers apparently did allocate the entire premium to the option exercised and there is no evidence that, prior to the ruling, the Treasury Department objected to allocations of this type.

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[16] SEC Report, pp. 42, 76–77.

[17] SEC. 117. CAPITAL GAINS AND LOSSES.

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(g) GAINS AND LOSSES FROM SHORT SALES, ETC.—For the purpose of this chapter—

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(2) gains and losses attributable to the failure to exercise privileges or options to buy or sell property shall be considered as short-term capital gains or losses; * * *

[18] However, sec. 1234 (a) and (b) of the 1954 Code provide that, where an option lapses, the purchaser of the option is deemed to have sold property (the option) on the day the option lapsed. So, if the option is a capital asset in the hands of the purchaser, he has a capital loss from the lapse and this loss may be either long-term or short-term, depending upon his holding period for the option.

[19] See Lucey and Bradley, "Income Tax Consequences of Investing in Puts and Calls," 50 ABAJ 494, 496 (1964).

[20] *Ibid.*

[21] The only difference between the early 1954 Code treatment and the 1939 Code treatment exists in the relatively rare case where both the "put" and "call" are allowed to lapse. In this case, since there is no basis adjustment to make, the entire amount of the premium under the 1954 Code results in ordinary income instead of the short-term capital gain treatment accorded under the 1939 Code.