August 16, 2004

Honorable Charles Grassley
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Honorable Max Baucus
Ranking Member
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Chairman Grassley and Senator Baucus:

I am writing this letter on behalf of the Tax Section to comment on Section 464(d) of H.R. 4520, the Jumpstart Our Business Strength Act (the "Bill"), as passed by the Senate on July 15, 2004.[1] Section 464 of the Bill, like its counterpart in Section 687 of the House's version of H.R. 4520, the American Jobs Creation Act of 2004, would make a number of modifications to the straddle rules and related provisions. The only material difference between the two bills is in Section 464(d), which would eliminate the Treasury's authority to define the types of "markets" on which qualified covered call options ("QCCs") may be traded, currently in Section 1092(c)(4)(B)(i), and explicitly prohibit Treasury

[1] The principal drafter of this letter was Michael Farber. Helpful comments were received from Kimberly Blanchard, David Chung, Peter Connors, Samuel Dimon, Erika Nijenhuis, Richard Reinhold and Michael Schler.

from adding "any exchange or market . . . to the exchanges or markets on which qualified covered call options may be traded."

In essence, Section 464(d) reverses Treasury Regulations Section 1.1092(c)-2 through -4 (the "Regulations"), promulgated in April 2002, which provide a framework under which certain over-the-counter and "flex" options qualify for the QCC exception from the straddle rules, which is otherwise available only to exchange-traded options. While we applaud the House and Senate for their efforts to address a number of the difficult issues set forth in our March 2000 "Report on Proposed Straddle Legislation" (the "Prior Report"), [2] we would not support the enactment of Section 464(d), for the reasons set forth herein. Instead, we believe that Treasury and the Internal Revenue Service should study the issue and, to the extent action is required to curtail potential misuses or abuses of the Regulations, provide guidance thereon by regulation or Notice.

As discussed in our Prior Report, one of the weaknesses of the straddle rules is that their operative provisions (loss deferral, holding

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[2] While this letter does not analyze or offer any view on other aspects of the bills' straddle proposals, we note one ambiguity in particular: Section 464(c) of the Bill (and Section 687(c) of the House bill) would repeal the "stock exception" to the straddle rules, providing instead in relevant part that stock is part of a straddle if at least one offsetting position is with respect to substantially similar or related property. Without more specificity, one result of this change would appear to be that stock and a short sale of identical stock would thereafter be a straddle. However, it is not entirely clear whether this result was intended. For example, the House report indicates that the current definition of "substantially similar or related property" (which cross-references Treasury regulations Section 1.246-5) "will continue to apply subsequent to repeal . . . and generally will constitute the exclusive definition of a straddle with respect to offsetting positions involving stock," citing Proposed Treasury Regulations Section 1.1092(d)-2(b). H.R. Rep. No. 548 (Part I), 108th Cong., 2d Sess., at 364 n.511. It is not clear whether the substance of Proposed Treasury Regulations Section 1.1092(d)-2(c) (which is cited elsewhere in the House report) would also continue to apply following repeal. That provision states essentially that stock and a short sale of stock are not a straddle. While we express no view on the merits of the issue, we think it should be made clear whether stock and a short sale of stock are intended to be a straddle following the proposed modification.

period tolling and interest capitalization) apply to all positions in a straddle, without regard to whether the taxpayer has substantially diminished its risk of loss with respect to a particular position. Thus, if a taxpayer writes a call option with respect to a portfolio position, absent the application of the QCC rules, both the "covered" position and the call option will be subject to the operative provisions of the straddle rules, notwithstanding that the taxpayer may retain substantial risk of loss with respect to the covered position.[3] In the Prior Report, we proposed that Congress change this result by providing that the straddle rules do not apply to straddle positions that merely hedge other straddle positions, unless the risk of loss with respect to the hedging position is itself substantially diminished (the "risk-reduction proposal"). This proposal has not been adopted in either bill. In connection with our risk- reduction proposal, we also recommended the repeal of the QCC rules, partly because they would no longer be necessary, as applied to the "cover stock," if our risk-reduction proposal were accepted.[4]

Since the submission of our Prior Report, Treasury and the Internal Revenue Service have promulgated the Regulations, which expanded the scope of the QCC rules, under the authority of Section 1092(c)(4)(H) and (B)(i), to include "flex" options and certain over-the-counter options acquired by broker-dealers or other specified entities, if certain conditions

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[3] Indeed, the legislative history of the qualified covered call rules states that "[t]he granting of a covered call option does not substantially reduce a taxpayer's risk of loss with respect to the underlying stock unless the option is deep-in-the-money." *See also* S. Rep. No. 313, 99th Cong., 2d Sess. 906 (1986) (approving of Treasury's conclusion in Revenue Ruling 80-238 that an out-of-the-money written call option does not reduce risk of loss with respect to stock for purposes of the dividends-received deduction holding period rules).

[4] In addition, we noted that the QCC rules as then constituted were both underinclusive (in that they then applied only where the written option was exchange-traded) and overbroad (in that they generally permit the recognition of losses on cash-settlement of the written option prior to the recognition of gain with respect to the covered position, notwithstanding that the risk with respect to the written option is reduced).

are met. While we continue to believe that consideration should be given to our risk-reduction proposal, in our September 2001 "Report on Proposed 'Straddle' Regulations," we supported the (then-proposed) Regulations as "a significant improvement over current law."

The policy underpinnings of proposed Section 464(d) are not clear to us. We can conceive of only two possible distinctions between exchange-traded options on the one hand and "flex" or over-the-counter options ("off-exchange options") on the other, from the perspective of the policy basis of the straddle rules: either it must be considered that the premiums generated in connection with off-exchange options are generally higher than those generated by exchange-traded options with the same or similar maturities (and thus that off-exchange options more substantially diminish taxpayers' risk of loss with respect to the cover stock than comparable exchange-traded options), or it must be considered that off-exchange options are more susceptible to abuse by virtue of the ability to "tailor" the options' terms and conditions and/or to negotiate with the counterparty regarding assignments, modifications and extensions. However, we do not view either of these possible objections as a sound basis for reversing the Regulations' expansion of the QCC rules to off-exchange options.

We are not aware of cases in which off-exchange options are being structured to generate meaningfully higher premiums than similar exchange-traded options, and we are not confident that it is possible to do so successfully under current law. Moreover, given the strong policy justification for treating exchange-traded options and off-exchange options equivalently under the straddle rules, we are of the view that it would be more appropriate for Treasury and the Internal Revenue Service to study the question and, if necessary, address the issue under their existing regulatory authority.[5]

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[5] For example, if it is determined that action is needed, consideration might be given to adding a requirement that the terms of off-exchange options and any related transactions be described in a disclosure to the Internal Revenue Service, or that off-exchange option premiums not exceed a specified percentage (which could, perhaps, vary

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We also are aware of no viable opportunities presented by off-exchange options with regard to "tailoring" of terms that would afford taxpayers any more risk protection than comparable exchange-traded options. Several commentators have suggested potential issues relating to the possible treatment of "binary" or "knockout" options,[6] or options embedded in other instruments such as indebtedness, as QCCs. In general, we are skeptical of such treatment under current law, and in any event we are not aware of any market activity involving the position that such instruments avoid the straddle rules. And, again, if such abuses exist, we believe that they would be more appropriately identified and addressed through the regulatory process than by means of a congressional limitation on the scope of the QCC rules.

Finally, while assigning, modifying or extending off-exchange options is certainly possible, we do not believe that this possibility affords taxpayers greater opportunity for risk reduction than do exchange-traded options. An assignment or significant modification of an option would presumably create a new option for U.S. federal income tax purposes, the consequences of which would need to be analyzed under the straddle rules. If a modification or extension did not amount to a "reissuance," then there would presumably be a valid question as to whether the option in fact satisfied the maturity and/or "adjusted strike price" limits of the Regulations.

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with the volatility of the underlying stock and/or the term of the option) of the fair market value of the stock on the option's trade date.

[6] "Binary" options provide for a fixed payout upon the occurrence of a specified event (*e.g.,* if the value of stock ABC, now worth $100X, is greater than $110X on a specified date, taxpayer pays counterparty $100X). "Knockout" or "barrier" options are options that automatically terminate if a specified event occurs (*e.g.,* taxpayer is obligated to deliver stock XYZ, now worth $100X, to counterparty at counterparty's request on date T in exchange for a specified strike price of $100X, provided that if the stock's price falls below $90X at any time prior to date T, the option "knocks out," or terminates, with no further payment due between the parties.)

We are not suggesting that there are no conceivable abuses of the QCC rules as currently constituted; however, we are not aware of abuses being effected (indeed, we are not confident that abuses can be effected) more readily in the off-exchange option markets than in the exchange-traded market. Moreover, again, in light of the strong policy justification for treating exchange-traded options and off-exchange options equivalently under the straddle rules, if any such abuse potential exists specifically with regard to off-exchange options, we are of the view that it would be more appropriate for Treasury and the Internal Revenue Service to address such issues under their existing regulatory authority.

As always, we would be happy to discuss this issue with you further.

Sincerely,

Lewis R. Steinberg
Chair

cc: Hon. Bill Thomas, Chairman, Committee on Ways and Means
Hon. John W. Snow, Secretary of the Treasury
Hon. Mark W. Everson, Commissioner, Internal Revenue Service
Edgar McClellan, Tax Counsel, Committee on Finance
Patrick Heck, Minority Chief Tax Counsel, Committee on Finance
Greg Nickerson, Tax Counsel, Committee on Ways and Means
John Buckley, Minority Chief Tax Counsel, Committee on Ways and Means
E. Ray Beeman, Legislative Counsel - Joint Committee on Taxation
Gregory F. Jenner, Acting Assistant Secretary (Tax Policy)
Eric Solomon, Deputy Assistant Secretary (Regulatory Affairs)
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Viva Hammer, Tax Litigation Counsel