PART II: OPTIONS

7550. What is an option?

An *option* is a contract in which an individual or entity, in return for consideration, grants for a specified time to the purchaser of the option the privilege of purchasing from the grantor (or selling to the grantor) certain specified property at a fixed price. Under an option contract, only the grantor (or writer) is obligated to perform; the purchaser (including any subsequent purchasers) may choose to exercise the option or may allow it to lapse. An option differs from a futures contract which, although similar to an option in that it provides for a purchase and sale of property at a fixed price at some time in the future, obligates both parties (or their successors) to perform (See Q 7582). The property specified in the option is referred to as the "underlying property" or "underlying security."

7551. What is a "cash settlement option"?

A *cash settlement option* is an option that on exercise settles in, or could be settled in, cash or property other than the underlying property.[1] For example, an option on a stock index that contemplates that cash, rather than stock, be transferred if the option holder elects to exercise the option is a cash settlement option.

7552. How are options classified for purposes of the federal income tax?

For federal income tax purposes, options are categorized as *listed* or *unlisted* options, and as *equity* or *nonequity* options.

An option is "listed" if it is traded on, or subject to the rules of, one of the following: (1) a national securities exchange registered with the SEC (as, for example, in the case of a stock option trading on the AMEX); (2) a domestic board of trade that has been designated as a contract market by the Commodities Futures Trading Commission (as in the case of certain options on regulated futures contracts); or (3) another exchange, board of trade, or market designated by the Secretary of the Treasury. All other options are considered "unlisted."[2]

A listed option covers 100 shares of a particular stock, specifies a fixed ("striking") price per share for exercise, and has a fixed expiration date. Only the premium (i.e., the price to be paid by the purchaser of the option) and the transaction costs are not fixed. The Options Clearing Corporation (OCC) assumes certain rights and obligations of the purchaser and writer of listed options; the writer is contractually bound only to the OCC and the owner may look to the OCC for performance if he or she elects to exercise the option.

Unlisted options are traded over the counter and have no fixed elements; the number of shares covered, striking price, premium, and expiration are all negotiable between the writer and purchaser. There is no intermediary organization (such as the OCC); therefore, the writer and purchaser remain tied together in a contractual relationship.

For the definitions of *equity* and *nonequity* options, see Q 7554 and Q 7576 respectively.

1. IRC Sec. 1234(c)(2)(B).
2. IRC Sec. 1256(g)(5).

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7553. How does the wash sale rule apply to transactions involving options?

A "wash sale" (see Q 7534) is a sale or other disposition of *stock or securities* in which the seller, within a 61-day period (beginning 30 days before and ending 30 days after the date of such sale or disposition), replaces those shares of stock or securities by acquiring (by way of a purchase or an exchange on which the full gain or loss is recognized for tax purposes), or entering into a contract or option to acquire, substantially identical *stock or securities*.[1] For the tax effect of a wash sale involving a sale of stock at a loss followed by a purchase of an option, see Q 7534.

Options to acquire or sell stock or securities are generally included in the definition of stock or securities for purposes of the wash sale rule (see Q 7536); consequently, the sale (at a loss) and reacquisition of options, with or without ownership of the underlying stock, would trigger the wash sale rule. Similarly, it would appear that "substantially identical stock or securities" would include "substantially identical options or contracts to acquire or sell stock or securities" as well.[2]

7554. What option contracts are classified as "equity" options?

The term "equity option" means any option (A) to buy or sell stock, *or* (B) the value of which is determined directly or indirectly by reference to any stock or any *narrow-based security index* (see below).[3] Thus, single stock futures and narrow-based stock index futures are classified as equity options. See Q 7580 and Q 7581 for the treatment of securities futures contracts. For example, an option on IBM common stock trading on the Chicago Board is an equity option. Likewise, a futures contract on IBM common stock is an equity option. In addition, an option on a narrow-based index of stock will generally be an equity option. Alternatively, "broad-based security index" means a group or index of securities that does *not* constitute a narrow-based security index.[4]

Single stock futures and narrow-based stock index futures are subject to the joint jurisdiction of the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). (Prior to December 21, 2000, if the CFTC had designated a contract market for trading an option the value of which was determined directly or indirectly by reference to a particular stock, or if the Treasury had determined that the requirements for CFTC designation had been met, then the option was a nonequity option.)[5] Broad-based stock index futures, however, remain under the exclusive jurisdiction of the CFTC.

An option may be an "equity" option regardless of whether it is listed or unlisted (see Q 7552). The term "equity option" includes an option on a group of stocks *only if* that group meets the requirements for a *narrow-based security index* (as defined in Section 3(a)(55)(A) of the Securities Exchange Act of 1934).[6] According to securities law provisions, the term "narrow-based security index" means an index:

1. IRC Sec. 1091(a); Treas. Reg. §1.1091-1(a).
2. See IRC Sec. 1091(a).
3. IRC Sec. 1256(g)(6). See also Section 3(a)(55)(A) of the Securities Exchange Act of 1934.
4. Commodities Exchange Act Rule 41.1(c).
5. IRC Sec. 1256(g)(6)(B), prior to amendment by CRTRA 2000.
6. IRC Sec. 1256(g)(6).

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(1) which has nine or fewer component securities;

(2) in which a component security comprises more than 30 percent of the index's weighting;

(3) in which the five highest weighted component securities in the aggregate comprise more than 60 percent of the index's weighting; *or*

(4) in which the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting have an aggregate dollar value of average daily trading volume of less than $50,000,000 (or in the case of an index with 15 or more component securities, $30,000,000), except that if there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting, such securities will be ranked from lowest to highest dollar value of average daily trading volume and will be included based on their ranking starting with the lowest ranked security.[1]

Any security index that does *not* have any of the four characteristics set forth in (1), (2), (3), or (4) is, in effect, a broad-based security index. For example, the Standard and Poor's 500 (S&P 500) would be a broad-based security index. Proposed rules state that indices that satisfy certain criteria are specifically *excluded* from the definition of narrow-based security index.[2]

7555. In the stock market, what is a "call" option? What is a "put" option?

In the case of options on individual stocks, a "call" option (or simply, a "call") is an option contract giving the owner thereof the right to *purchase* from the writer of the call, at any time before a specified future date and time, a stated number of shares of a particular stock at a specified price.[3] See Q 7556 through Q 7579 for the tax treatment of various transactions involving the purchase, holding, and disposition of puts, calls, nonequity options, and combinations thereof.

A "put," on the other hand, is an option contract giving the owner thereof the right to *sell* to the writer of the put (i.e., to "put it to him or her"), at any time before a specified future date and time, a stated number of shares of a particular stock at a specified price.[4]

In any case, only the grantor of an option is obligated to perform on it; the purchaser or subsequent owner of a "call" or "put" may choose to dispose of it or allow it to expire. The owner of an option (whether it is a put or a call) is referred to as holding a "long" position; the writer (i.e., grantor or seller) of an option is referred to as holding a "short" position. Thus, it is always the holder of the short position who is obligated to perform on the contract and the holder of the long position who may choose to exercise the contract or permit it to lapse.

1. Sec. 3(a)(55)(B) of the Securities Exchange Act of 1934. See also Commodities Exchange Act Rule 41.1(e).
2. See Commodities Exchange Act Rule §§41.1.(c), 41.1(e), 41.12, 41.13, 41.14, "Background and Overview of New Rules." See also Securities and Exchange Act §§240.3a55-2, 240.3a55-3.
3. Rev. Rul. 78-182, 1978-1 CB 265; Rev. Rul. 58-234, 1958-1 CB 279.
4. Rev. Ruls. 78-182, 58-234, 1978-1 CB 265.

The price a purchaser pays to the writer of an option as consideration for the writer's obligation under the option is referred to as the "premium" or "option premium."

7556. How are puts and calls held by an investor treated for income tax purposes?

"Puts" and "calls" (whether listed or unlisted) are capital assets in the hands of an investor.[1] Furthermore, puts and calls on individual stocks are "equity options" and, thus, are not subject to the mark-to-market tax rules as are "nonequity options."[2] The tax treatment of equity options depends on the circumstances of their exercise, lapse, or termination (See Q 7557 through Q 7575). See Q 7576 and Q 7577 for the treatment of nonequity options.

The contemporaneous holding of a call option and granting of a put option with respect to an equity interest in a pass-through entity may constitute a "constructive ownership transaction" under IRC Section 1260 (See Q 7609 to Q 7610).

7557. How is an investor taxed upon purchase of a put or call?

An investor realizes no taxable gain or loss on the purchase of a listed or unlisted put or call; neither does the investor incur any deductible expense; but the purchase may trigger adverse tax consequences, as described below, depending on other positions held by the taxpayer.

Future regulations will provide that if a taxpayer enters into certain option transactions (e.g., purchases a put) and the underlying property becomes substantially worthless, the taxpayer will recognize gain in the same manner as if the contract were closed when the property became substantially worthless.[3]

Option Premium

The premium paid to purchase a put or call (generally referred to as the "option premium") represents the cost of the option and is a nondeductible capital expenditure.[4] As such, the premium is carried in a deferred account as a capital expenditure made in an uncompleted transaction until the option is exercised (see Q 7561, Q 7566), allowed to expire without exercise (see Q 7560, Q 7565), or otherwise terminated. See Q 7558, Q 7559, Q 7563, Q 7564.[5]

Commissions

Commissions paid in connection with the purchase of a put or call are aggregated with, and treated for tax purposes as part of, the total "option premium" paid by the investor to purchase the option; commissions are *not* tax deductible.[6]

1. See IRC Sec. 1234(a); Treas. Reg. §1.1234-1(a).
2. IRC Secs. 1256(g), 1256(b).
3. See IRC Sec. 1233(h)(1).
4. Rev. Rul. 78-182, 1978-1 CB 265.
5. Rev. Rul. 71-521, 1971-2 CB 313.
6. Rev. Rul. 58-234, 1958-1 CB 279.

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Effect of Purchase on Other Transactions

Depending on the taxpayer's other holdings, the purchase of a put may trigger any of several provisions that may affect the holding period or tax treatment of the put and the other holdings.

Certain combinations of options, or options held contemporaneously with offsetting positions that have the effect of reducing both the taxpayer's risk of loss and opportunity for gain, may trigger constructive sales treatment under IRC Section 1259. See Q 7606 to Q 7608.

The contemporaneous holding of a call option and granting of a put option with respect to an equity interest in a pass-through entity may constitute a "constructive ownership transaction" under IRC Section 1260. See Q 7609 and Q 7610.

The purchase of a put is treated under IRC Section 1233(b) in the same manner as a short sale and may result in the creation of a tax straddle with respect to the underlying stock.[1] Each may adversely affect the taxation of the stock that is subject to the put option. For details, see Q 7562, Q 7563, and Q 7566.

The purchase of an option may trigger the wash sale rule if it occurs within 30 days before or after the sale of "substantially identical stock or securities."[2] The purchase of a put option may also create a conversion transaction if the purchase of the put and the acquisition of the underlying stock occurred contemporaneously. For an explanation of the conversion transaction rules, see Q 7604 to Q 7605.

For an explanation of the short sale rules, see Q 7524 to Q 7528. For an explanation of the tax straddle rules, see Q 7587 to Q 7603. For an explanation of the wash sale rule, see Q 7534 to Q 7536.

7558. If the owner of an unlisted call sells it prior to exercise or expiration, how is the sale taxed?

The sale is taxed to the seller as the sale of a capital asset.[3] The seller realizes capital gain to the extent that the selling price exceeds the tax basis in the call option; if the tax basis exceeds the selling price, the seller realizes a capital loss. (See Q 608 for the treatment of capital gains and losses.) An investor's tax basis in a call option is the total option premium (including commissions) paid to acquire the call.[4] The nature of capital gain or loss realized on the sale of a call option will ordinarily depend on the length of the taxpayer's holding period (See Q 605 and Q 608).[5]

For an explanation of the effect of the wash sale rules on transactions involving options, see Q 7534 and Q 7553.

1. IRC Sec. 1233(b).
2. IRC Sec. 1091(a).
3. IRC Sec. 1234(a).
4. See IRC Sec. 1234(a); Rev. Rul. 78-182, 1978-1 CB 265.
5. Treas. Reg. §1.1234-1(a).

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Certain combinations of options, or options held contemporaneously with offsetting positions that have the effect of reducing both the taxpayer's risk of loss and opportunity for gain, may trigger constructive sale treatment under IRC Section 1259 (See Q 7606 to Q 7608).

The contemporaneous holding of a call option and granting of a put option with respect to an equity interest in a pass-through entity may constitute a "constructive ownership transaction" under IRC Section 1260 (see Q 7609 and Q 7610).

If a call option was part of a tax straddle in the hands of the investor, the tax straddle rules may result in a deferral of the recognition of a loss realized on a sale of the call option and, furthermore, may have unfavorable effects on the characterization of gains and losses realized on positions making up the straddle. See Q 7587 to Q 7603 for details.

7559. If the owner of a listed call terminates a position by making a closing sale in the market, how is the transaction taxed?

A "closing sale" (i.e., the "sale" in the market of an option identical to the one held) is taxed as the sale of a capital asset. To the extent that the premium received in the closing sale (less any commission paid by the seller) exceeds the tax basis in the call option, the owner realizes a capital gain; if the premium received in the closing sale is less than the tax basis, the difference is a capital loss. (See Q 608 for the treatment of capital gains and losses.) An investor's tax basis in a call option is the total option premium (including commissions) paid to acquire the call.[1] The nature of capital gain or loss realized on the sale of a call option will ordinarily depend on the length of the taxpayer's holding period (See Q 605 and Q 608).[2]

For an explanation of the effect of the wash sale rules on transactions involving options, see Q 7534 and Q 7553.

Certain combinations of options, or options held contemporaneously with offsetting positions that have the effect of reducing both the taxpayer's risk of loss and opportunity for gain, may trigger constructive sales treatment under IRC Section 1259 (See Q 7606 to Q 7608).

The contemporaneous holding of a call option and granting of a put option with respect to an equity interest in a pass-through entity may constitute a "constructive ownership transaction" under IRC Section 1260 (See Q 7609 and Q 7610).

If a call option was part of a tax straddle in the hands of the investor, the tax straddle rules may result in a deferral of the recognition of a loss realized on a closing sale of the call option; it may also have unfavorable effects on the characterization of gains and losses realized on positions making up the straddle. See Q 7587 to Q 7603 for details.

1. IRC Sec. 1234(a); Rev. Rul. 78-182, 1978-1 CB 265.
2. Treas. Reg. §1.1234-1(a).

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7560. How is the owner of a call taxed if the owner allows it to expire without exercising it?

If allowed to expire without exercise (i.e., lapse), a listed or unlisted call is deemed to have been sold or exchanged on the expiration date.[1] Thus, the amount of the option "premium" paid by the owner to acquire the call will be treated as a capital loss, the treatment of which will depend on the holding period of the call (See Q 605). (See Q 608 for the treatment of capital gains and losses).[2]

Certain combinations of options, or options held contemporaneously with offsetting positions that have the effect of reducing both the taxpayer's risk of loss and his or her opportunity for gain. may trigger constructive sales treatment under IRC Section 1259 (See Q 7606 to Q 7608).

The contemporaneous holding of a call option and granting of a put option with respect to an equity interest in a pass-through entity may constitute a "constructive ownership transaction" under IRC Section 1260 (See Q 7609 and Q 7610).

If a call option was part of a tax straddle in the hands of the investor, the tax straddle rules may result in a deferral of the recognition of the loss realized on the expiration of a call option; it may also have unfavorable effects on the characterization of gains and losses realized on positions making up the straddle. See Q 7587 to Q 7603 for details.

7561. How is an owner taxed if a call is exercised?

The owner of a call (whether listed or unlisted) will realize no taxable gain or loss on the exercise of the call option and the purchase of the underlying stock. But for purposes of determining gain or loss in a subsequent sale or exchange of that stock, the option premium paid by the owner to acquire the call is added to the tax basis in the stock.[3]

Certain combinations of options, or options held contemporaneously with offsetting positions that have the effect of reducing both the taxpayer's risk of loss and opportunity for gain, may trigger constructive sales treatment under IRC Section 1259 (See Q 7606 to Q 7608).

The contemporaneous holding of a call option and granting of a put option with respect to an equity interest in a pass-through entity may constitute a "constructive ownership transaction" under IRC Section 1260 (See Q 7609 and Q 7610).

7562. What effect does the purchase of a put have on the underlying stock?

Because the acquisition of a listed or unlisted put—other than a "married" put (See Q 7567)—is treated as a short sale for the purposes of IRC Section 1233(b) (i.e., the treatment of gains and losses from short sales), the purchase of a put by a taxpayer who holds substantially identical property (e.g., such as the underlying stock) will, at the very least, generally have the

1. IRC Sec. 1234(a)(2).
2. Treas. Reg. §1.1234-1(b); Rev. Rul. 78-182, 1978-1 CB 265.
3. Rev. Rul. 78-182, 1978-1 CB 265.

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effect of cancelling the holding period of the underlying stock, as explained below. In addition, it is possible that the purchase of a put could constitute a constructive sale (i.e., a short sale) of an appreciated financial position if the underlying stock has appreciated[1] (See Q 7606 to Q 7608).

In its provision governing the treatment of short sales,[2] the IRC states that if (1) on the date the put is acquired the purchaser of the put has held the underlying stock for a period of time that is less than the long-term capital gain (or loss) holding period for that stock (See Q 605 and Q 608) or (2) the underlying stock is acquired after the acquisition of the put and on or before the date the put is exercised, sold, or expires, then the holding period of the underlying stock will be deemed to begin on the date the purchaser of the put disposes of the underlying stock, exercises the put, sells the put, or allows the put to lapse, whichever occurs first. Any previous holding period is lost.[3] For this purpose, the exercise or failure to exercise the option will be considered a closing of the short sale.[4]

The holding period of underlying stock held for more than the long-term capital gain (or loss) holding period before the put is acquired is not affected by the rules of IRC Section 1233, but if the transaction is construed as a constructive sale of an appreciated financial position (and assuming no exceptions apply), underlying stock will be treated as sold and reacquired on the date the put is purchased. Thus a new holding period would begin.[5]

If an investor owns (1) the stock that underlies the put option, (2) stock or securities that are substantially identical to the underlying stock, or (3) other positions that are offsetting with respect to the put option, the purchase of a put may trigger the loss deferral, wash sale, and short sale rules which apply to tax straddles. See Q 7587 to Q 7603 for details. Such a combination of holdings may also trigger a series of constructive sales under IRC Section 1259.[6]

For the tax treatment of capital gains and losses, see Q 608. For an explanation of the effect of the wash sale rule on transactions involving options, see Q 7534 and Q 7553. For an explanation of the conversion transaction rules with respect to transactions involving the contemporaneous acquisition of a put option and the underlying (or substantially identical) stock, see Q 7605.

7563. How is the owner of an unlisted put taxed if the put is sold instead of exercising it?

The sale is taxed as the sale of a capital asset.[7] Thus, the seller realizes capital gain to the extent that the selling price exceeds the tax basis in the put; if the tax basis is greater than the selling price, the seller realizes a capital loss. (See Q 608 for the treatment of capital gains and losses.) The seller's tax basis in a put is the total option premium paid to acquire the put.[8]

1. See IRC Secs. 1259(b)(1), 1259(c)(1)(A).
2. IRC Section 1233.
3. Rev. Rul. 78-182, 1978-1 CB 265.
4. IRC Sec. 1233(b).
5. See IRC Sec. 1259(a).
6. See IRC Secs. 1259(e)(1), 1259(e)(3).
7. IRC Sec. 1234(a).
8. Rev. Rul. 78-182, 1978-1 CB 265.

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The length of the taxpayer's holding period will ordinarily determine the nature of the gain or loss. See Q 605 and Q 608. But a capital gain realized on the sale of a put (other than a "married" put) is, under the short sale rules, automatically a short-term capital gain if (1) as of the date the put was acquired the underlying stock had been held by the put holder for a period that is less than the long-term capital gain (or loss) holding period for that stock (see Q 605), or (2) the underlying stock was acquired after the put was purchased but on or before the date the put was sold.[1] For the tax treatment of "married" puts, see Q 7567.

Certain combinations of options, or options held contemporaneously with offsetting positions that have the effect of reducing both the taxpayer's risk of loss and opportunity for gain, may trigger constructive sales treatment under IRC Section 1259. See Q 7606 to Q 7608.

If a put option was part of a tax straddle in the hands of the investor, the tax straddle rules may result in a deferral of the recognition of a loss realized on the sale of a put option, and may have additional unfavorable effects on the characterization of gains and losses realized on positions making up the straddle. See Q 7587 to Q 7603 for details.

For an explanation of the effect of the wash sale rule on transactions involving options, see Q 7534 and Q 7553. For the effect that the acquisition and subsequent sale of a put has on the underlying stock, see Q 7562. For an explanation of the effect of the conversion transaction rules on transactions involving the contemporaneous acquisition of a put option and the underlying (or substantially identical) stock, see Q 7605.

7564. How is the owner of a listed put taxed if the owner liquidates a position by making a "closing sale" in the market?

Any gain or loss realized by the owner of a listed put in a closing sale (i.e., the "sale" in the market of a put identical to the one held) is capital gain or loss.[2] (See Q 608 for the treatment of capital gains and losses.) The amount of capital gain or loss realized is the difference between the premium the owner receives in the closing sale and the premium the owner paid to acquire the put in the first place.

The length of the taxpayer's holding period will ordinarily determine the nature of the gain or loss (See Q 605 and Q 608). A *capital gain* realized in a closing sale of a put (other than a "married" put) is, however, under the short sale rules, automatically a short-term capital gain if (1) as of the date the put was acquired the underlying stock had been held by the put holder for a period that is less than the long-term capital gain (or loss) holding period for that stock (see Q 605) or (2) the underlying stock was acquired after the put was purchased, but on or before the closing sale of the put.[3] For the tax treatment of "married" puts, see Q 7567.

Certain combinations of options, or options held contemporaneously with offsetting positions that have the effect of reducing both the taxpayer's risk of loss and opportunity for gain, may trigger constructive sales treatment under IRC Section 1259 (see Q 7606 to Q 7608).

1. IRC Sec. 1233(b); Rev. Rul. 78-182, above.
2. IRC Sec. 1234(a).
3. IRC Sec. 1233(b); Rev. Rul. 78-182, 1978-1 CB 265.

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If a put option was part of a tax straddle in the hands of the investor, the tax straddle rules may result in deferring recognition of a loss realized on the closing sale, and may have additional unfavorable effects on the characterization of gains and losses realized on positions making up the straddle. See Q 7587 to Q 7603 for details.

For an explanation of the effect of the wash sale rules on transactions involving options, see Q 7534 and Q 7553. For the effects that the acquisition and subsequent liquidation of a put have on the underlying stock, see Q 7562. For an explanation of the effect of the conversion transaction rules on transactions involving the contemporaneous acquisition of a put option and the underlying (or substantially identical) stock, see Q 7605.

7565. How is an owner of a put taxed if the put expires before exercising it?

Except in the case of a "married" put (see Q 7567), any put allowed to expire without exercise (i.e., lapse) is deemed to have been sold or exchanged on the expiration date, and the owner realizes capital loss in the amount of the total option premium paid to acquire the put.[1] (See Q 608 regarding the treatment of capital losses.) The length of the taxpayer's holding period will ordinarily determine the nature of the gain or loss (See Q 605 and Q 608).[2]

Future regulations will provide that if a taxpayer enters into certain option transactions (e.g., the purchase of a put) and the underlying property becomes substantially worthless, the taxpayer will recognize gain in the same manner as if the contract were closed when the property became substantially worthless.[3]

Certain combinations of options, or options held contemporaneously with offsetting positions that have the effect of reducing both the taxpayer's risk of loss and opportunity for gain, may trigger constructive sales treatment under IRC Section 1259 (See Q 7606 to Q 7608).

If a put option was part of a tax straddle in the hands of the investor, the tax straddle rules may result in deferring recognition of the loss realized on the expiration of the put and, in addition, may have unfavorable effects on the characterization of gains and losses realized on positions making up the straddle. See Q 7587 to Q 7603 for details.

For the effect that the acquisition and subsequent lapse of a put have on the underlying stock, see Q 7562. The tax effects of allowing "married" puts to lapse are discussed in Q 7567.

7566. How is the owner of a put taxed if it is exercised?

When a put (listed or unlisted) is exercised, the owner sells the underlying stock to the writer of the put. It is that sale, not the put, which is taxed.

To determine gain or loss on a sale made pursuant to the exercise of a put, the owner offsets the total option premium paid for the put against the price received for the stock (i.e., the striking price) to arrive at the total amount realized in the sale. If the total amount realized exceeds

1. IRC Sec. 1234(a)(2); Treas. Reg. §1.1234-1(b); Rev. Rul. 78-182, 1978-1 CB 265.
2. Treas. Reg. §1.1234-1(a).
3. See IRC Sec. 1233(h)(1).

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the tax basis on the stock sold, the excess is capital gain; if the amount realized is less than the tax basis, the difference is capital loss.[1] See Q 608 for the treatment of capital gains and losses.

The nature of a capital *loss* realized on a sale made pursuant to the exercise of a put will generally depend on how long the stock has been held by the put holder. Similarly, the character of a capital *gain* realized on the exercise of a put generally depends on how long the put holder has owned the stock sold. But a capital gain realized on the exercise of a put – other than a "married" put (See Q 7567) – is, under the short sale rules, a *short-term* capital gain if: (1) as of the date the put was acquired, the underlying stock had been held by the put holder for a period of time that is less than the long-term capital gain (or loss) holding period for that stock (See Q 605), or (2) the underlying stock was acquired after the put was purchased but on or before the date the put was exercised.[2]

Certain combinations of options, or options held contemporaneously with offsetting positions that have the effect of reducing both the taxpayer's risk of loss and opportunity for gain, may trigger constructive sales treatment under IRC Section 1259. It is unclear whether the acquisition of a put will be treated as a short sale under IRC Section 1259 (as it is under IRC Section 1233(b)) (see Q 7562). If so, the constructive sales rules explained in Q 7606 to Q 7608 may affect the treatment of the put option, upon acquisition, upon exercise, or both.

If the put option was part of a tax straddle in the hands of the investor, the tax straddle rules may result in deferring recognition of a loss realized on the exercise of the put and, in addition, may have unfavorable effects on the characterization of gains and losses realized on positions making up the straddle. See Q 7587 to Q 7603 for details.

If the put option was part of a conversion transaction in the hands of the investor, the conversion transaction rules may result in a portion of any gain being treated as ordinary income (see Q 7604 and Q 7605).

7567. What is a "married" put? How does the taxation of a "married" put differ from that of an ordinary put?

"Married" puts are a special exception to the treatment under IRC Section 1233 of the purchase of a put as a short sale. There are three requirements for a put to be treated as a "married" (or "identified") put, as follows: (1) it must be purchased *on the same day* as stock the investor intends to use in exercising the put; (2) the option must specify that such stock is to be used in exercising it, *or* the investor's records must identify within 15 days after the acquisition of the property the stock that is to be so used; and (3) if the put is exercised, it must be exercised through the sale of the property so identified.[3]

In other words, the stock is "married" to the put. A married put may be listed or unlisted. Unlike ordinary put options, the acquisition of a married put is *not* treated as a short sale for

1. Rev. Rul. 78-182, 1978-1 CB 265; Rev. Rul. 71-521, 1971-2 CB 313.
2. IRC Sec. 1233(b); Rev. Rul. 78-182, 1978-1 CB 265.
3. IRC Sec. 1233(c); Treas. Reg. §1.1233-1(c)(3).

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federal income tax purposes.[1] If a married put is exercised by delivering stock other than the identified stock, the short sale rules will apply as explained in Q 7566.

In the event the put expires without being exercised, its cost will be added to the taxpayer's basis in the stock with which the option was identified; it will not be a capital loss in the year of expiration as would be the case with an ordinary put option.[2]

It is not clear whether a married put that falls within the definition of a tax straddle will be subject to the straddle rules (See Q 7587 to Q 7603), nor whether one that falls within the definition of a conversion transaction will be subject to the conversion transaction rules (See Q 7604 and Q 7605). It also is unclear how the sale of an unlisted married put or the liquidation of a married listed put in a closing sale is treated for income tax purposes; however, it would seem that the short sale rules would not be triggered and a gain or loss would be realized on the sale as discussed in Q 7563 and Q 7564.

7568. How is the "premium" received by the writer of a "put" or "call" taxed?

Regardless of whether the option is listed or unlisted, the receipt by the writer of an option premium is not a taxable event. The premium is not included in income at the time of receipt, but is carried in a deferred account as part of an uncompleted transaction until such time as the option is exercised, is sold, or lapses; or the writer's obligation is terminated in a closing transaction.[3] Under future regulations, if the underlying property on which the option is written becomes worthless, the taxpayer will recognize gain or loss in the same manner as if the contract were closed when the property became substantially worthless.[4]

7569. Are the commissions a writer of a put or call pays in connection with the sale of that option tax deductible?

No. Commissions paid by a writer to sell a put or call (whether listed or unlisted) merely reduce the total "option premium" received in consideration for the obligations under the option.[5]

7570. If a put or call expires without exercise, how is the writer taxed?

When a put or call (whether listed or unlisted) expires without exercise (i.e., lapses), the premium that has been carried by the writer in a deferred account since the option was sold (see Q 7568) is recognized as short-term capital gain and included in the writer's gross income for the tax year in which the option expired.[6] See Q 608 for the treatment of capital gains and losses.

Under regulations expected to be issued in the future, if the underlying property on which the option is written becomes worthless, the taxpayer will recognize gain or loss in the same manner as if the contract were closed when the property became substantially worthless.[7]

1. IRC Sec. 1233(c); Rev. Rul. 78-182, 1978-1 CB 265; Rev. Rul. 71-521, 1971-2 CB 313.
2. IRC Secs. 1233(c), 1234(a)(3)(C); Rev. Rul. 78-182, 1978-1 CB 265.
3. Rev. Rul. 78-182, 1978-1 CB 265; Rev. Rul. 68-151, 1968-1 CB 363.
4. See IRC Sec. 1233(h)(1).
5. Rev. Rul. 58-234, 1958-1 CB 279; Rev. Rul. 68-151, 1968-1 CB 363.
6. IRC Sec. 1234(b)(1); Rev. Rul. 78-182, 1978-1 CB 265.
7. See IRC Sec. 1233(h)(1).

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7571. How is the writer of a call taxed when the option is exercised by the owner?

When a listed or unlisted call is exercised and the writer thereof is called on to sell the underlying stock, the writer adds the amount of the option "premium" received for writing the call to the total striking price to determine the total amount realized on the sale. Then, to the extent that the total amount realized exceeds the writer's tax basis in the stock sold, he or she realizes a capital gain; if the writer's tax basis exceeds the total amount realized, he or she has a capital loss. (See Q 608 for the treatment of capital gains and losses.) The nature of such gain or loss generally depends on the holding period of the stock sold (See Q 605 and Q 608), regardless of the time the "call" was outstanding.[1]

If an investor writes a call option as part of an overall tax straddle, the tax straddle rules may result in deferring recognition of a loss realized on the exercise of the call option and, in addition, may have unfavorable effects on the characterization of gains and losses realized on positions making up the straddle. See Q 7587 to Q 7603 for details.

It is unclear whether the writer of a call will be deemed to have entered into a contract to sell the underlying property, within the meaning of IRC Section 1258(c)(2). For more on conversion transactions, see Q 7604 and Q 7605. See Q 7588 for an explanation of the rules governing covered call options.

7572. How is the writer of a put taxed when the option is exercised by the owner?

The writer of a put (listed or unlisted) realizes no taxable gain or loss on the purchase of the underlying stock pursuant to exercise of the put. But for purposes of determining the writer's gain or loss on a subsequent sale of the underlying stock, the writer's tax basis in that stock is reduced by the amount of the option "premium" received in the original sale of the put. Furthermore, the holding period of the underlying stock begins on the date of its purchase, not on the date the put was written.[2]

7573. How is the writer of an unlisted put or unlisted call taxed if the writer repurchases the option from the holder?

If the writer of an unlisted option repurchases the option from its holder, he or she will realize *short-term* capital gain or loss to the extent of the difference between the premium paid to repurchase the option and the premium originally received by the writer.[3] See Q 608 for the treatment of capital gains and losses.

Certain combinations of options, or options held contemporaneously with offsetting positions that have the effect of reducing both the taxpayer's risk of loss and his or her opportunity for gain, may trigger constructive sales treatment under IRC Section 1259. The operation of

1. Rev. Rul. 78-182, 1978-1 CB 265.
2. Rev. Rul. 78-182, 1978-1 CB 265.
3. IRC Sec. 1234(b); Rev. Rul. 78-181, 1978-1 CB 261.

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these rules is explained at Q 7606 to Q 7608, and the effect of closing out or reopening certain transactions that are subject to constructive sale treatment is explained at Q 7607.

The contemporaneous holding of a call option and granting of a put option with respect to an equity interest in a pass-through entity may constitute a "constructive ownership transaction" under IRC Section 1260 (see Q 7609 and Q 7610).

7574. How is the writer of a listed call or listed put taxed if he terminates his obligation by making a closing purchase in the market?

Any gain or loss realized by the writer of a listed option in a closing purchase (i.e., the "purchase" in the market of an option identical to the one written) is short-term capital gain or loss.[1] The amount of such gain or loss will be the difference between the premium paid by the writer in the closing purchase and the premium previously received in the original sale of the option.[2] See Q 608 for the treatment of capital gains and losses.

Certain combinations of options, or options held contemporaneously with offsetting positions that have the effect of reducing both the taxpayer's risk of loss and opportunity for gain, may trigger constructive sales treatment under IRC Section 1259. The operation of these rules is explained at Q 7606 to Q 7608, and the effect of closing out or reopening certain transactions that are subject to constructive sale treatment is explained at Q 7607.

The contemporaneous holding of a call option and granting of a put option with respect to an equity interest in a pass-through entity may constitute a "constructive ownership transaction" under IRC Section 1260. See Q 7609 and Q 7610.

It is unclear whether the writer of a call will be deemed to have entered into a contract to sell the underlying property within the meaning of IRC Section 1258(c)(2). For more on conversion transactions, see Q 7604 and Q 7605.

7575. Other than stock options, what kinds of options are classified as "equity" options? How are these options taxed?

For taxable years beginning after 2001, the term "equity option" includes an option on a group of stocks *only if* that group meets the requirements for a *narrow-based security index* (as defined in Section 3(a)(55)(A) of the Securities Exchange Act of 1934) (See Q 7554).[3] For taxable years beginning before 2000, options *other than stock options* could be classified as "equity" options for federal income tax purposes if their value was determined by reference to a *group* of stocks or stock index, but they were of a type that was ineligible to be traded on a commodity futures exchange. (An example of such an option would have been an option contract on a sub-index based on the price of nine hotel-casino stocks.) An equity option could be either a *listed option* or an *unlisted option* (i.e., traded over-the-counter or otherwise).[4]

1. IRC Sec. 1234(b); Rev. Rul. 78-182, 1978-1 CB 265.
2. Rev. Rul. 78-182, 1978-1 CB 265.
3. IRC Sec. 1256(g)(6).
4. See IRC Sec. 1256(g)(6), prior to amendment by CRTRA 2000.

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These "other" equity options were generally taxed under the same rules that apply to stock options. See Q 7550 to Q 7574 for details. For the application of the straddle rules to such options, see Q 7587 to Q 7603.

7576. What is a "nonequity" option?

For federal income tax purposes, a *nonequity option* is any option traded on a national securities exchange or commodity futures exchange (or other exchange, board of trade, or market designated by Treasury) that is not an "equity" option.[1] Thus, options on regulated futures contracts are nonequity options. In addition, the term "nonequity option" includes any option traded on a national securities exchange (or other market designated by Treasury) whose value is determined directly or indirectly by reference to *broad-based* groups of stocks and *broad-based* stock indexes.[2] See Q 7554 for the definition of "broad-based security index."

The IRS has ruled that options to buy or sell stock that are based on a stock index and that are traded on (or subject to the rules of) a qualified board or exchange meet the requirements for contract market designation and are nonequity options if (a) the options provide for cash settlement, and (b) the Securities and Exchange Commission has determined that the stock index is a "broad-based" index. These options are considered "IRC Section 1256 contracts" (See Q 7586). Furthermore, warrants that are based on a stock index and that are economically, substantively identical in all material respects to options based on a stock index are treated as options based on a stock index.[3]

As one of several types of "IRC Section 1256 contracts," a nonequity option is taxed under the "mark to market" requirements (See Q 7586). Such a position is excluded from the definition of an *appreciated financial position* under IRC Section 1259(b)(2)(B) (See Q 7606). However, depending on the taxpayer's other holdings, it appears that a constructive sale could result from the acquisition of a nonequity option (See Q 7606 to Q 7608).[4]

For an explanation of the application of the conversion transaction rules to transactions involving the contemporaneous acquisition of a put option and the underlying (or substantially identical) stock, see Q 7605.

7577. How are nonequity options taxed?

Nonequity options are taxed under the mark-to-market rules that apply to regulated futures contracts and other IRC Section 1256 contracts (see Q 7586).

Like any other position taxed under the "mark to market" requirements, a nonequity option is excluded from the definition of an *appreciated financial position* under IRC Section 1259(b)(2)(B) (see Q 7606). However, it appears that, depending on the taxpayer's other holdings, the acquisition of a nonequity option could be construed as a constructive sale of a position that is

1. IRC Secs. 1256(g)(3), 1256(g)(7).
2. See H.R. Conf. Rep. No. 106-1033 (CRTRA 2000); IRC Sec. 1256(g)(6).
3. Rev. Rul. 94-63, 1994-2 CB 188.
4. IRC Sec. 1259(c)(1)(E).

substantially identical to the nonequity option or the property underlying it.[1] Future regulations may clarify this and other issues with respect to the application of IRC Section 1259 to options transactions.

For the tax treatment of a nonequity option that is part of a tax straddle, see Q 7587 to Q 7603. For the tax treatment of a nonequity option that is considered part of a conversion transaction, see Q 7604 and Q 7605.

7578. What is a "spread" transaction?

A "spread" is a position consisting of both long (purchased) and short (sold) options of the same type (i.e., put or call). The options may have different exercise prices and exercise dates. The basic purpose of the various types of spread transactions is to limit or define the risks of the options transaction. The "spread" is the actual dollar difference between the buy premium and the sell premium.[2]

> *Example*: ILM corporation's stock is trading at $91 in November, but Ms. Noel expects it to decline. She writes an ILM January 80 call and collects a premium of $1300 for it. Since she does not own ILM stock and does not wish to assume the risks of writing an uncovered call, Ms. Noel also buys an ILM January 90 call at a cost of $600. If the price of ILM drops to $79, Ms. Noel will have made a profit of $700 (the difference between the premium she paid and the premium she collected). If the price does not drop, she has limited her loss to $300 (the $1000 difference between the strike prices of the two options minus the $700 net premium).

The three basic types of spreads are vertical (or price), horizontal (or time), and diagonal (combination of vertical and horizontal). Spreads are also (regardless of their type) referred to either as credit, debit, or even. In a debit spread, the costs of the long (purchased) position exceed the proceeds of the short (sold) position. In a credit spread, the proceeds of the short position exceed the cost of the long position. If the costs and proceeds are equal, the spread is even.

Vertical Spreads. A vertical spread (also referred to as a price, money, or perpendicular spread) is the simultaneous purchase and sale of puts or calls with the same underlying security and expiration date, but with different strike prices. An investment in a vertical spread is based upon the expectation that the option purchased is undervalued relative to the option sold.

Horizontal Spreads. A horizontal spread (also referred to as a time or calendar spread) is the simultaneous purchase and sale of puts or calls with the same underlying security and strike price, but with different expiration dates. Horizontal spreads are purchased in anticipation that over time the spread will widen.

Diagonal Spreads. A diagonal spread is a combination of a vertical spread and a horizontal spread; thus, it is the simultaneous purchase and sale of puts and calls with the same underlying security but with different strike prices and expiration dates.

1. See IRC Sec. 1259(c)(1)(E).
2. See *Resser v. Comm.*, TC Memo 1991-423; *Laureys v. Comm.*, 92 TC 101 (1989), *acq. in part, nonacq. in part*, 1990-1 CB 1, footnotes 5 and 11.

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Within each of the categories described above (vertical, horizontal, diagonal), a spread can also be characterized as a bull spread, bear spread, or butterfly spread. A *bull spread* is the combination of a long position at a lower strike price and a short position at a higher strike price. It is so named because it will generally be profitable if the underlying security goes up in value. In a *bear spread* the opposite is true: the strike price of the long position is higher than the strike price of the short position, and the investor will generally profit if the trading price of the underlying security goes down. A *butterfly spread* is a combination in which the investor holds three put or call positions in the same underlying security at three different strike prices. The expiration dates may be the same or the spread may be "diagonalized" by having different expiration dates.

Butterfly spreads are so named because the respective "sizes" of the positions invoke the image of a butterfly. The Tax Court has described butterfly spreads as follows: "The highest and lowest strike positions are one-half the size of the middle position, and the middle position (the body) is long (or short) and the highest and lowest positions (the wings) are short (or long). The highest and lowest positions are equidistant from the middle position."[1]

See Q 7579 for an explanation of the tax treatment of spread transactions.

7579. How are spread transactions taxed?

Generally, spread transactions are subject to the tax straddle rules to the extent that the positions in the spread are offsetting (see below). Consequently, certain spreads will apparently be subject to the constructive sale treatment of IRC Section 1259 (See Q 7606 to Q 7608).[2]

Generally, positions are offsetting if the taxpayer substantially reduces his or her risk of holding one position with respect to personal property by holding another position with respect to personal property, whether or not it is of the same type.[3] See Q 7587 for an explanation of the IRC definition of "offsetting" and Q 7593 for an explanation of the treatment of tax straddles.

The Tax Court has taken the position that spread transactions are not "similar arrangements" within the meaning of IRC Section 465(b)(4), and that losses on stock option spreads are thus not limited by the "at risk" rules.[4] But the IRS, issuing a very limited partial acquiescence to the Laureys decision, noted its nonacquiescence as to whether offsetting positions in stock options are subject to the limitations of IRC Section 465(b)(4). See Q 7912 and Q 7913 for an explanation of the "at risk" rules.

To the extent that one position of a spread is offset by only a portion of the other position, only those portions of the spread that offset one another will be treated as offsetting (and subject to the tax straddle rules) unless the position is part of a larger tax straddle.[5] Apparently, any options positions that are not offset by other positions will be taxed under the general rules governing equity options (See Q 7554 to Q 7575).

1. See *Laureys v. Comm.*, 92 TC 101 (1989), *acq. in part, nonacq. in part*, 1990-1 CB 1, footnotes 5 and 11. See also Andrea S. Kramer, *Financial Products: Taxation, Regulation and Design* (New York: John Wiley & Sons, Inc. 1991, Supp. 1993), §5.4(c).
2. See IRC Sec. 1259(c)(1)(E); Conference Committee Report for TRA '97.
3. IRC Sec. 1092(c).
4. See *Resser v. Comm.*, TC Memo 1991-423; *Laureys v. Comm.*, 92 TC 101 (1989), *acq. in part, nonacq. in part*, 1990-1 CB 1, footnotes 5 and 11.
5. IRC Sec. 1092(c)(2)(B).

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Positions consisting entirely of options that are IRC Section 1256 contracts (i.e., dealer equity options and nonequity options) are exempt from the tax straddle rules and, instead, taxed under the mark-to-market rules in IRC Section 1256. Such positions will not constitute an "appreciated financial position" (See Q 7606), but may constitute a constructive sale of another position (see Q 7607). See Q 7586 for an explanation of IRC Section 1256 treatment. Spreads consisting of at least one, but not all, IRC Section 1256 contracts are subject to the rules for "mixed straddles." For an explanation, see Q 7599.

Aside from the special rules for IRC Section 1256 contracts (see above), it is clear that certain combinations of options (to be specified in future regulations) or options held contemporaneously with offsetting positions that have the effect of reducing both the taxpayer's risk of loss and opportunity for gain, will trigger constructive sales treatment under IRC Section 1259, unless certain exceptions apply (See Q 7606 to Q 7608).[1]

A spread transaction that is a straddle under IRC Section 1092(c) may also constitute a conversion transaction. See Q 7604 and Q 7605 for the definition and tax treatment of conversion transactions.

1. IRC Sec. 1259(c)(1)(E).

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