The Impact of Proposed Derivatives Tax Reforms on Investors and the U.S. Listed Options Markets

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BATS Options, BOX Options Exchange, Chicago Board Options Exchange, International Securities Exchange, NASDAQ OMX PHLX, NASDAQ Options Market, NYSE Amex Options, NYSE Arca Options and OCC (formerly The Options Clearing Corporation)
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As the United States Congress considers the difficult task of comprehensive tax reform, there are concerns that some proposals related to derivatives taxation would unfairly penalize individual investors and other taxpayers who use exchange-traded (or listed) options.

While legislation may be needed to provide certainty in the tax treatment of certain newer and more complex derivatives, well-established and relatively simple rules that have been in place for 35 years provide that certainty for exchange-traded options. Moreover, listed options are traded in a highly regulated exchange environment, are subject to SEC oversight, are fully transparent, and are cleared centrally by the OCC.

This white paper looks primarily at the draft proposal regarding the uniform taxation of derivatives (the “Draft Proposal”) released by House Ways and Means Committee Chairman Dave Camp. The Draft Proposal appears to have served as a basis for the derivatives taxation proposal included in the President’s FY 2014 budget proposal. The U.S. Securities Markets Coalition (the “Coalition”) commends the open process followed by Chairman Camp as he undertakes comprehensive tax reform. It is this process that has allowed the Coalition to provide comments on the problems with the Draft Proposal as it applies to listed options, and hopefully better inform the upcoming tax reform efforts and debates with regard to the listed options markets and the investors who use them.

Based on the tax consequences of the Draft Proposal, we believe that individuals and other investors would cease using listed options to reduce the risks of owning stocks or to generate additional income from their stock holdings. For example, if an investor holding appreciated stock bought a put option to hedge against downside risk, the stock would be treated as sold
under the proposal and tax would be due on the gain deemed to be recognized. The same
would be true if an investor holding appreciated stock wrote a call option on the stock to
generate additional income. In addition, by marking to market all options and taxing gains as
ordinary income, the Draft Proposal would result in a higher effective tax rate on options as
compared to alternative investments that are not marked to market.

The significant tax costs that the Draft Proposal would impose on the use of exchange-traded
options would greatly harm the listed options markets. Liquidity would be reduced and trading
costs would increase. Repercussions would be felt in the underlying stock markets, as investors
and other market participants would be unable to allocate efficiently the risks associated with
owning stock. As applied to exchange-traded options, the proposal would distort economic
decision-making and replace the well-established and relatively simple tax rules for options
with a harsh, burdensome and overly complicated regime.

It is the Coalition’s impression that these results are unintended consequences stemming from
the decision to provide uniform tax treatment for all derivatives. While we understand the
desirability of providing clear rules for newer financial products with uncertain tax treatment—
such as credit default swaps—options have been traded on national securities exchanges in the
U.S. for 40 years and the basic tax rules for listed options continue to work well for our millions
of customers. We believe that the major policy goals for tax reform—simplicity, fairness,
efficiency and administrability—all strongly favor retention of the current-law treatment of
listed options over the approach set forth in the Draft Proposal.
The U.S. options exchanges offer options on roughly 3,700 individual stocks, exchange-traded funds (“ETFs”) and equity-related indexes. In 2012, almost 3.7 billion options contracts on individual stocks and ETFs were traded on U.S. options exchanges, with each contract representing options on 100 shares. Taking into account index options, some 4 billion options contracts were traded on U.S. options exchanges in 2012.

Total option premiums (the money changing hands in an options transaction) for the year amounted to $1.4 trillion. All options traded on U.S. options exchanges are centrally cleared by the OCC (formerly known as the Options Clearing Corporation), the largest equity derivatives clearing organization in the world. The U.S. options exchanges are national securities exchanges and are regulated by the Securities and Exchange Commission (the “SEC”) just like U.S. stock exchanges. All aspects of U.S. exchange-traded options are fully transparent.

The options exchanges play an important role in the nation’s economy. One of their most important functions is to permit individuals and firms that do not want to bear certain risks—particularly short-term risks—to transfer those risks to others who are more willing to bear them. In the words of the SEC, exchange-traded options:

“provide a means for shifting the risk of unfavorable short-term stock price movements from owners of stock who have, but do not wish to bear these risks, to others who are willing to assume such risks in anticipation of possible rewards from favorable price movements.”

SEC, Report of the Special Study of the Options Markets, House Committee on Interstate and Foreign Commerce (Committee Print 96-IFC3) 96th Cong. 1st Sess. 2

The existence of options markets serves to enhance the liquidity of the underlying equity markets. The options markets afford an efficient and cost-effective means of adjusting an investment’s risk/return characteristics and provide market participants with the ability to create more diverse risk-return alternatives. These features tend to make participation in the underlying equity markets more attractive to a greater number of participants, thus increasing the liquidity of those markets.
Many individual investors actively use exchange-traded options. An analysis by two options exchanges of options transactions in the first quarter of 2013 found that over 50% of all customer orders were placed by individual investors.

Recognizing that many individuals participate in the options markets, Congress enacted legislation in 2008 requiring brokers to report basis and gross proceeds information on options transactions to individual taxpayers and to the Internal Revenue Service.

In order for individuals to enter into an options transaction, they must meet the requirements established by their brokerage firm for options trading. These requirements are designed to determine whether options transactions are a suitable investment activity for the individual in light of the individual's investment experience and other factors.

Brokerage firms typically use “levels” to determine the types of options transactions a customer may engage in, with Level 1, which typically authorizes writing covered calls and buying protective puts, being the most basic. According to one major retail brokerage firm, the average account size approved for Level 1 options transactions is roughly $47,000. This firm also reports that 24% of its daily trades for its customers are options transactions. Another major retail brokerage firm reports that it has over a million customer accounts that have requested and been approved for options trading at Level 1 or higher and that some 30% of its trades for customers are options transactions.

**DEFINITION**

Call Options: The holder of a call option has the right (but not the obligation) to purchase specified property, such as 100 shares of AT&T stock, for a specified price (referred to as the strike price or exercise price) during a specified period of time. The writer (or grantor) of a call option has the obligation to sell the specified property for the specified price if the holder exercises the option.

**COVERED CALL**

Joe owns 100 shares of Facebook stock which is trading for $25 a share. Joe writes (sells) a 60-day call option on 100 shares of Facebook with an exercise price of $30 and receives a total premium of $200.

Individuals use exchange-traded options primarily for two purposes: to generate additional income from their stock holdings and to reduce risks associated with holding stock. In the first case, individuals sell call options on stock that they hold in order to generate additional income from the premiums they receive for selling the calls. This strategy is commonly referred to as writing or selling “covered call options” or “covered calls.”

As far back as 1984, Congress recognized that writing covered call options is a popular investment strategy. As observed in the Ways & Means Committee report accompanying the 1984 legislation that extended the “tax straddle” rules to certain options.
“One widely used investment strategy that would be affected by the extension of the straddle rules to stock options and stock involves writing call options on stock owned by the taxpayer. The Committee believes that it may be appropriate to exempt these transactions where they are undertaking primarily to enhance the taxpayer’s investment return on the stock and not to reduce the taxpayer’s risk of loss on the stock.”


The second way in which individuals typically use options is to reduce risk associated with their stock holdings. For example, an individual holding stock during a time of market unrest may buy a put option on the stock to protect against a significant decline in the value of the stock. Buying a put option is essentially like buying insurance.

Mutual funds, a primary investment vehicle for individual investors, are also major participants in the listed option markets. Individuals invest in mutual funds in order to obtain the benefits of diversification and professional investment management expertise. Investment managers of mutual funds use options in a wide variety of ways, both to hedge against risks and to fine tune the risk/reward profile of the fund’s portfolio securities. The vast majority of investors in mutual funds are individuals.
Current Tax Treatment of Options

The tax treatment of listed options under current law is governed by well-established rules that are relatively simple and straightforward. Most of these rules were promulgated by the IRS some 35 years ago. These rules have worked well and the basic terms of listed options have not changed since the rules were issued. Here is a brief summary of the basic rules:

- **Long calls and long puts** that are closed out or expire result in capital gain or loss. Such gain or loss is long-term capital gain or loss if the option is held for more than one year. If a long call is exercised, the cost of the call is added to the taxpayer’s basis in the stock for purposes of computing gain or loss on a later sale of stock; no gain or loss in the call is recognized when it is exercised. If a long put is exercised, the cost of the put reduces the proceeds from the sale of the underlying stock for purposes of computing gain or loss on the stock.

- **Written calls and written puts** that are closed out or expire result in short-term capital gain or loss regardless of how long they are outstanding. If a taxpayer is assigned on a written call, the premium received for writing the call increases the proceeds from the sale of the underlying stock for purposes of computing gain or loss on the stock. (Assignment occurs when the holder of a listed option decides to exercise the option, the obligation to perform is then randomly “assigned” to a person who has written the identical option.) If a taxpayer is assigned on a written put, the premium reduces the taxpayer’s basis in the stock purchased.

- **Options that are “section 1256 contracts”** are taxed under special rules. These options are marked to market (treated as sold) on the last day of the taxable year, with gain or loss recognized at that time. Gain or loss on these options is taxed as 60% long-term capital gain and 40% short-term capital gain. For customers, options treated as section 1256 contracts are generally limited to listed options on broad-based indexes (such as the S&P 500).

Special rules apply to options that are part of two-sided positions known as “straddles.” Any loss on a position in a straddle is deferred for tax purposes to the extent there is unrecognized gain at the end of the year in a position that was offsetting to the loss position. An important exception to the straddle rules applies to “qualified covered call options,” which generally speaking are call options that are written primarily to generate additional income from stock holdings (and not to reduce risk of owning the stock).
Key Draft Tax Reform Proposal Aspects Related to Options

The Draft Proposal would radically change the long-standing tax treatment of listed options. All derivatives, including listed equity options, would be marked to market (treated as sold) on the last day of the taxable year. All gain or loss would be treated as ordinary income/ordinary loss. Ordinary income/ordinary loss treatment would also apply when an option or other derivative is closed out or expires. In addition, if a call option is exercised, the call option would be treated as sold and gain or loss in the call option would be recognized at that time. The same would apply if a taxpayer is assigned on a written put.

The Draft Proposal would also radically change the tax treatment of stock held by investors when the investor buys a put option on the stock or writes a covered call on the stock. The Draft Proposal uses the current tax code concept of a “straddle” to determine when the special rules will apply. If stock is part of a straddle that includes an option or other derivative (a “mixed straddle”), then the special rules apply. The Draft Proposal would repeal the qualified covered call exception to the straddle definition so that stock and a qualified covered call would comprise a “mixed straddle.” The rules with respect to stock that is part of a mixed straddle would provide as follows:

- If a taxpayer holds appreciated stock and buys a put or writes a call on the stock, the stock would be treated as sold at that time and gain would be recognized for tax purposes. However, if there is a loss in the stock when the option transaction is entered into, the loss would not be recognized. Rather, the loss would be suspended and taken into account when the taxpayer ultimately sells the stock.

- The stock is taxed in the same way as a derivative while it is part of a mixed straddle. Thus, gain or loss in the stock while the associated option position is open would be treated as ordinary income/ordinary loss rather than capital gain or loss and the stock would be marked to market (along with the option) at year-end. If the option position is closed out or expires, the stock is again marked to market and the gain or loss in the stock while the option position was open is taken into account at that time (as ordinary income or ordinary loss). If the taxpayer continues to hold the stock, any further gain or loss in the stock is once again treated as capital gain or loss.

- The taxpayer’s holding period in the stock is suspended during the period that the associated option position is open.
Impact on Investors Holding Stock and Options Combinations

The adverse impact of these rules on common transactions involving stock and listed options can be illustrated by the following examples:

EXAMPLE 1
Alice has held 1,000 shares of AT&T stock for 30 years. Her basis is $5 a share and AT&T is currently trading for $35 a share. In a time of market turmoil like the recent financial crisis, Alice is concerned that the stock may decline significantly. She does not want to sell the stock because she likes getting the dividend. So she buys put options on 1,000 shares of AT&T with a strike price of $25 a share.

CURRENT LAW: Alice has no gain or loss from buying the put.

DRAFT PROPOSAL: Alice is treated as selling her AT&T stock for $35 a share when she buys the put options, with a resulting taxable gain of $30,000. Alice will need to come up with the cash to pay the tax.

EXAMPLE 2
Fred buys 100 shares of Intel stock for $20 a share. After holding the Intel stock for 3 months and at a time when Intel is trading at $25 a share, Fred writes a 60-day, $30 call on the 100 shares of Intel stock for $200 to generate some additional income. Assume that the option expires worthless after 60 days and that Intel is trading for $26 a share when the option expires.

CURRENT LAW: Fred has no gain or loss when he writes the covered call. He has a $200 short-term capital gain when the call expires. Fred’s holding period in the stock continues to accrue while the written call is outstanding.

DRAFT PROPOSAL: Fred is treated as selling his Intel stock for $25 a share when he writes the call and he recognizes $500 of short-term capital gain at that time. When the option expires, Fred recognizes $200 of ordinary income on the option and $100 of ordinary income on the stock (because the stock appreciated from $25 to $26 while the option was outstanding). Fred is treated as having a basis of $26 a share in the Intel stock for purposes of computing subsequent gain or loss and has a 3-month holding period in the stock. (His holding period is suspended during the 60-day period in which the written call was outstanding.)
As can be seen from Example 2, the Draft Proposal would require capturing and retaining many more data points than current law and these data points—such as the values of the stock when options are entered into or expire—would have no relevance except for tax purposes. Further, it is worth noting that broker reporting of a taxpayer’s basis in stock will not reflect the basis adjustments and character switches associated with mixed straddles because brokers are not required to take the straddle rules into account in calculating the basis amounts and character of gain/loss they report to their customers and to the IRS. As a result, basis reporting by brokers would be incorrect, which would impose even greater compliance burdens on taxpayers and administrative burdens on the IRS.

As illustrated by the foregoing examples, the Draft Proposal would effectively impose a tax penalty on individuals and other taxpayers who use exchange-traded options to reduce the risks of owning stock or to generate additional income from their stock holdings. The Draft Proposal, as applied to exchange-traded options, would thus discourage risk reduction, distort rational economic decision-making and replace the well-established and relatively simple tax rules for options with a harsh, burdensome, and overly complicated regime. The Draft Proposal would directly affect the basic options transactions most commonly used by individual investors, namely writing covered calls and buying protective puts. The tax penalty associated with these transactions would lead taxpayers, both individuals and institutions, to cease entering into these transactions. The result would be significantly reduced liquidity in the stock and options markets as taxpayers would be unable to reduce or adjust risk without incurring substantial tax costs. The Draft Proposal would thus dramatically interfere with the symbiotic relationship between the stock and listed options markets with resulting losses in efficiency to the economy.

The Draft Proposal also raises significant uncertainties as to when stock would be subject to these rules. The Draft Proposal uses the current tax code definition of “straddle,” with certain modifications (such as repeal of the qualified covered call exception), to determine whether the special rules for stock that is part of a mixed straddle would apply. It is often difficult to determine if a taxpayer has a straddle. The definition of a straddle requires that the taxpayer have substantially diminished his or her risk of loss from holding a position by entering into an offsetting position. While in some cases it is clear that there is a substantial diminution of risk, in other cases it is not. For example, if a taxpayer owns stock trading at $50 a share and buys a 30-day put option to sell the stock for $35, has the taxpayer substantially diminished risk of loss of owning the stock? What if there is less than 10% chance that the stock would drop below $35 a share within the 30 days?

In addition, if a straddle does exist, it is often difficult to determine exactly what positions are part of the straddle. As a simple example, consider a taxpayer who holds 200 shares of General Electric stock and buys a put option to sell 100 shares. Does the straddle include all 200 shares or just 100 shares? If just 100 shares, which 100 shares? The Draft Proposal would exacerbate this problem by repealing the current rule allowing taxpayers to identify the positions that make up a straddle. In 2004, Congress expanded and modified the identified straddle rules.
as a means of reducing uncertainties created by “unbalanced straddles.” It is not clear what underlies the decision to repeal this recent improvement in the law.

While these uncertainties exist under current law, the questions of whether a straddle exists and if so what positions are part of the straddle are often moot. For example, if a taxpayer holds two potentially offsetting positions and closes both of them out before the end of the taxable year, there is typically no need to determine if a straddle existed. Similarly, if a taxpayer does not recognize a loss during the year from a position that is potentially part of a straddle, it may not be necessary to determine if that position was part of a straddle. In contrast, under the Draft Proposal, taxpayers will need to have certainty as to whether a “mixed straddle” exists and, if so, which positions are part of the mixed straddle in order to determine if their appreciated stock is treated as sold during the year and/or whether gain or loss on the stock is ordinary or capital or some combination of the two.

The problems presented by the Draft Proposal are greatly increased by the fact that it would repeal the qualified covered call exception to the straddle rules. As a result, the Draft Proposal will apply to the very common strategy of writing covered call options. We are not aware of any tax policy support for treating stock as sold merely because the taxpayer has written a covered call option on the stock. Under current law, a taxpayer who enters into a transaction that eliminates substantially all risk of loss and substantially all opportunity for gain in an appreciated financial position is treated as having sold the appreciated financial position. The tax policy rationale for this treatment is plain: the taxpayer has essentially sold the position as an economic matter. However, it will be difficult to explain to taxpayers why they are treated as having sold their appreciated stock if they merely write a covered call option to generate income or buy a put option on the stock to limit downside risk.

Treating appreciated stock as sold when a taxpayer enters into an option transaction that creates a mixed straddle also raises a technical and practical issue. If a taxpayer holds appreciated stock and buys a put option on the stock at, say, 10:30 in the morning, is the relevant value of the stock for computing gain/loss its fair market value at that time (i.e., 10:30) or is it some other value (such as the closing price for the day or weighted average price for the day)? Obviously the price of a stock can change substantially during the course of a trading day, but the practical and administrative burdens associated with using the value at the time the put was purchased are likely to be excessive.

A separate technical issue with significant implications is raised by the proposed rule that would treat all offsetting positions as positions with respect to personal property. We are unsure of the specific reasons for this proposed rule, but it would effectively override the special tax code definition of personal property that limits the straddle rules as they apply with respect to stock. Pursuant to this provision, stock is subject to the straddle rules only if the stock is offset by a position with respect to such stock or with respect to substantially similar or related property (“SSRP”). The SSRP limitation is the foundation for determining whether stock and a position (other than another position in the stock itself) comprise a straddle. Critical
guidance on the SSRP limitation is contained in the regulations and provides relative certainty in many common situations that the straddle rules do not apply. For example, if a taxpayer holds a diversified portfolio of stocks and hedges general market risk by buying a put option on a broad-based index (e.g., the S&P 500 index), the regulations provide that unless there is a 70% overlap between the stocks in the portfolio and the stocks in the index, the SSRP requirement is not satisfied and therefore no straddle is created. As a result, such hedges of general market risk typically do not create a straddle under current law. If the SSRP limitation is removed, the broad-based index put and the diversified portfolio of stocks (or some subset of the portfolio) may well comprise a mixed straddle because the index put may substantially diminish the risk of loss associated with the portfolio (or some subset of the portfolio).

The apparent result would be that a taxpayer entering into a hedge of general market risk associated with a diversified portfolio of stocks would be taxed on the built-in gain with respect to all of his appreciated stocks, while the built-in losses on his depreciated stocks would remain unrecognized.

It appears that all of the highly undesirable and unwarranted results described above are not intentional. Rather, they flow from the decision to treat all derivatives the same. While uniform treatment is certainly one tax policy objective, there are other policy objectives that are more important. As discussed below, these other policy objectives—simplicity, fairness, efficiency, and administrability—weigh heavily against applying the Draft Proposal to combinations of stock and exchange-traded options.
The tax treatment of listed equity options is governed by well-established rules that are relatively simple, straightforward and easy to understand. These rules were promulgated not long after options first traded on a national securities exchange. These rules have worked well for the past 35 years and we have not heard of any significant concerns or uncertainties with their application. The fact that the rules were adopted a number of years ago is not an argument for replacing them. Not only do they continue to work well, but the listed equity options to which they apply are essentially the same as they were 35 years ago. These options are not newly developed or exotic financial products with uncertain tax treatment. Nor did listed equity options contribute to the financial crisis.

The vast majority of listed equity options are short-term instruments. Based on an analysis conducted by the Chicago Board Options Exchange (“CBOE”), approximately 83% of customer opening transactions in 2012 had terms of 3 months or less and approximately 77% had terms of 2 months or less. Thus, listed options typically do not involve the type of long-term deferral associated with certain other financial instruments. Marking these options to market, and the associated complexity and compliance burdens, thus seem unwarranted.

We recognize that a mark-to-market approach can more practically be applied to exchange-traded options and other exchange-traded derivatives than to over-the-counter derivatives and to illiquid assets generally. We also are aware that some have suggested limiting mark-to-market to exchange-traded financial instruments. However, the obvious consequence would be that taxpayers will be encouraged to increase their use of over-the-counter (“OTC”) derivatives, a result that is diametrically at odds with the on-going regulatory efforts, mandated by Dodd Frank, to migrate OTC derivatives on to exchanges and other trading platforms with centralized clearing. We would also note that while market values for actively traded listed options are readily observable, that is not necessarily true for thinly traded options. Options are listed on roughly 3,700 individual stocks, ETFs and equity-related indexes and there are numerous options with respect to each of those underliers (i.e., puts and calls with various exercise prices and expiration dates, known as options “series.” There are currently about 525,000 options “series” listed on U.S. options exchanges.) For many of these individual options, there may be no trades for weeks at a time. In such situations, and others that arise frequently in practice, it can be very difficult to determine a reasonable approximation of market value. For example:

- If the last trade price is used, it could be below the current market bid price or above the current market offer price for the option in question and would not represent market value.
If the mid-point between the year-end bid/ask prices is used, it could be subject to manipulation by a party posting an aggressive bid or offer for just a single contract on December 31.

Determining fair market value for such thinly traded options will thus require application of conventions or models that may produce unreasonable results.

Marking listed options and other derivatives to market will result in a higher effective tax rate for these instruments as compared to stocks, bonds and other assets that are not marked to market. Options and other derivatives would thus be “tax disadvantaged” relative to such other assets. This will be true even if the prevailing nominal tax rates are reduced as compared to current law and apply to gains from all assets. In order to avoid distorting economic decision-making in the selection of investments, a reduced tax rate should apply to options if they are to be marked to market.

In this regard, we note that the Draft Proposal would repeal section 1256, which provides that certain listed options (generally broad-based index options that compete with futures contracts) are marked-to-market and taxed as 60% long-term gain or loss and 40% short-term gain and loss (“60/40 tax treatment”). This tax treatment was adopted in the early 1980’s and the reduced tax rate was adopted to offset the disadvantages of marking to market and the inability to obtain long-term gain treatment for longer-term positions. We recognize that 60/40 tax treatment might well need to be addressed in the context of fundamental tax reform that dramatically reduces overall tax rates as envisioned by Chairman Camp. However, given that marking to market results in a higher effective tax rate when the same nominal rate applies to both mark-to-market assets and assets taxed based on realization principles, it is reasonable to apply a lower nominal rate to mark-to-market assets.
Coalition View of the Draft Proposal in Light of Tax Policy Goals

The principal policy objective of the Draft Proposal on the tax treatment of derivatives appears to be to apply uniform tax treatment to all derivatives. The concept of uniformity, however, can be applied in different ways. For example, one uniform approach to financial products would be to tax financial products with similar economics according to similar tax rules regardless of the particular “cubbyhole” a particular financial product might fall into. This approach would increase efficiency because a taxpayer would not select a particular financial product over another financial product with similar economics in order to obtain more favorable tax treatment. The Draft Proposal would not achieve uniform tax treatment in this sense. It would apply a single mark-to-market approach to all derivatives even if they have very dissimilar economics and without regard to whether they are governed by clear and sensible rules under current law. In this regard, it paints with too broad a brush.

In addition, the Draft Proposal would result in significant situations in which financial positions with similar economics are taxed in radically different ways. For example, direct ownership of stock will be taxed very differently from “synthetic” ownership of stock through a combination of other financial instruments (such as a long call option and short put option with the same strike price coupled with a zero-coupon bond). This difference in treatment will result in “clientele” effects as taxpayers who want ordinary income or loss treatment will use “synthetic stock” and taxpayers preferring capital gain or loss treatment will own the stock directly.

Similarly, a taxpayer who wants ordinary income/loss treatment for stock could buy the stock and write a call option with a strike price that is much higher than the current price. For example, a taxpayer could buy stock trading at $50 and write a 60-day call option with a strike price of $90. This would create a mixed straddle under the Draft Proposal and the taxpayer would receive ordinary income/loss treatment for the stock even though there is no meaningful economic difference between the combined stock and written call positions and just holding the stock. Taxpayers investing in stock will thus effectively be able to elect whether they want capital gain/loss or ordinary income/loss treatment. Other examples of disparate treatment of economically similar positions include: (i) an equity swap as compared to a fully leveraged stock purchase financed by the stock seller; (ii) stock coupled with a put option as compared to stock purchased with nonrecourse debt; and (iii) stock coupled with a forward contract to sell the stock as compared to a zero-coupon bond.

Moreover, uniformity is not an ultimate tax policy goal in itself. Rather, it is an intermediate goal that in some contexts furthers the ultimate tax policy goals of simplicity, fairness, efficiency, and administrability. As applied to listed options, however, the uniform mark-to-
market approach in the Draft Proposal, and the associated rules for stock that is part of a “mixed straddle,” do not further these important goals:

**Simplicity.** The Draft Proposal would introduce great complexity in the tax treatment of exchange-traded options and stock as compared with the well-established rules of current law.

**Efficiency.** The Draft Proposal would distort economic behavior and discourage individuals and other taxpayers from reducing risk or generating income in economically rational ways.

**Fairness.** The Draft Proposal would trigger gains—but not losses—in stock when a related option position is established. Taxpayers would need to come up with cash to pay the tax on unrealized gains.

**Administrability.** The Draft Proposal’s deemed sales of stock, suspended holding periods, suspended losses, and character conversion rules (with stock moving from capital gain or loss to ordinary income or loss and back again) would necessitate extensive recordkeeping to capture and retain data that is completely unnecessary under current law and that would not be retained for any non-tax purpose.

These tax policy considerations, as well as the other concerns expressed above, all strongly favor retention of the current-law treatment of listed options over the approach set forth in the Draft Proposal.