Comments
of the
U.S. Securities Markets Coalition
regarding
Financial Products Tax Reform
submitted to the
Savings & Investment Working Group
of the
Senate Finance Committee

April 15, 2015

The members of the U.S. Securities Markets Coalition (the "Coalition")[1] welcome the opportunity to submit these comments regarding proposals in the area of financial products tax reform that would affect the tax treatment of exchange-traded equity options and related investments in publicly traded stock. Equity options have been traded on U.S. securities exchanges for over 40 years. U.S. options exchanges currently offer options on roughly 3,700 individual stocks, exchange-traded funds ("ETFs"), and equity-related indices. In 2014, over 3.8 billion options contracts on individual equities were traded on U.S. options exchanges, with each contract covering 100 shares of the underlying stock. Individual taxpayers are significant participants in the listed options markets. While precise statistics are not available, it is estimated that approximately one-fourth of the volume on U.S. options exchanges is attributable to individuals, with millions more individuals participating indirectly through mutual funds and other investment vehicles.

Our comments address two specific proposals: First, we describe our strong concerns regarding the proposal to mark to market exchange-traded options and associated investments in stock. Second, we renew our proposal, which has also been advanced by others, for the adoption of a capital asset hedging regime that would achieve a clear reflection of income.

Proposals to Mark to Market Exchange-Traded Options and Related Investments in Stock

We are very concerned about proposals that would (i) treat all exchange-traded options as sold at the end of the year, (ii) treat appreciated stock as sold if a taxpayer enters into an option to manage risk associated with owning the stock, and (iii) radically alter the tax treatment of stock while a related option position is outstanding. Proposals having this effect, such as the uniform mark-to-market proposal for derivatives proposed by Chairman Camp of the House Ways & Means Committee and by the Administration in recent budgets, would adversely affect

[1] The members of the Coalition are: BATS Options, the BOX Options Exchange, the Chicago Board Options Exchange, the International Securities Exchange, NASDAQ OMX PHLX, NASDAQ Options Market, NYSE Amex Options, NYSE Arca Options, and the Options Clearing Corporation.

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individuals and other taxpayers using exchange-traded options to manage risks associated with investments in publicly traded stocks. Such proposals would also distort rational economic decision-making and replace the well-established and relatively simple tax rules for exchange-traded options with a harsh, burdensome and overly complicated regime.

More specifically, our concerns regarding the application of these mark-to-market proposals to exchange-traded options and associated investments in stock include the following:

- The proposals would effectively impose a tax penalty on individuals and other taxpayers who use exchange-traded options to manage the risks associated with investing in stock. A taxpayer who hedges appreciated stock with an exchange-traded option is treated as having sold the stock for its fair market value and must pay tax on unrealized appreciation in the stock even though the taxpayer has not sold the stock and may continue to hold the stock as an investment for many years. While such deemed sale treatment may make sense as a matter of tax policy if the taxpayer eliminates substantially all of the economics of owning the stock,[2] the mere fact that a taxpayer has reduced risk is not a sound basis for treating the taxpayer as having sold the stock. The fact that the proposals do not similarly treat any loss as currently recognized compounds the unfairness of this approach.

- Complex tax accounting rules would be needed to coordinate changes in the value of the stock and the option while the offsetting option position is in place. Chairman Camp's version of the mark-to-market proposal includes complex and burdensome rules to coordinate the timing and character of gain or loss on stock and an offsetting option. These rules include (i) marking the stock to market when the option is closed out or expires (as well as at year-end when the option is marked to market); (ii) changing the character of gains and losses on the stock from capital to ordinary while the option is outstanding; (iii) interim basis adjustments to the stock to reflect changes in value while the option is in place; and (iv) suspension or forfeiture of holding period in the stock. The proposal would also require recording and retaining (often for many years) data points that are not necessary to record or retain under current law, such as the value of the underlying stock at the time the offsetting option is entered into and at the time the option is closed out or expires.

  The Administration's version of the proposal does not attempt to address these complexities, leaving the development of these extremely difficult rules to regulations. We strongly believe that the mark-to-market proposals cannot be evaluated without an understanding of what these rules will look like.

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[2] *See* I.R.C. § 1259.

- The “substantial diminution” standard is vague and creates significant uncertainties. The mark-to-market proposals would apply these rules to stock if the option “substantially” diminishes the risk of loss in the stock. The “substantial diminution” concept is borrowed from the straddle rules in Code section 1092. It is often extremely difficult to determine if this standard is met. For example, if a taxpayer owns 100 shares of stock trading at $50 a share and buys a 30-day put option with a strike price of $40, has the taxpayer substantially diminished his or her risk of loss on the stock? Does the volatility of the stock need to be taken into account in answering these types of questions? When a straddle does exist, it can often be difficult to determine which positions are part of the straddle. For example, if a taxpayer owns 200 shares of stock and buys a put option on 100 shares, does the straddle include all 200 shares of stock or just 100 shares? If only 100 shares are part of the straddle, which 100 shares? The existence of these and other ambiguities may be acceptable in the context of anti-abuse rules, such as the straddle rules, but it is unreasonable to have such uncertainties in a regime that will treat a taxpayer as having sold appreciated stock merely as a result of hedging activity.

The principal policy objective of proposals to mark all derivatives to market 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 uniform mark-to-market proposals would not achieve uniform tax treatment in this sense. They 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, the proposals paint with too broad a brush.

Moreover, uniformity is not an ultimate tax policy goal in itself.[3] 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 exchange-traded options, however, the uniform mark-to-market approach in the proposals, and the associated rules that would apply when a taxpayer hedges stock with an option, do not further these important goals:

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

[3] The recent experience with efforts to adopt a uniform definition of a “child” for tax purposes may serve as an object lesson for this point.

- Efficiency -- The proposals would distort economic behavior and discourage individuals and other taxpayers from using listed equity options to reduce risk or generate income in economically rational ways.

- Fairness -- The proposals 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.

- Adminstratibility -- The rules that would be needed to coordinate the treatment of stock and an offsetting option position -- including deemed sales of stock, basis adjustments, suspended gains and losses, and character conversion rules (with stock moving from capital gain or loss to ordinary income or loss and back again) -- would require 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.

Based on these tax policy considerations, and the other concerns expressed above, such mark-to-market proposals, if adopted, should not apply to exchange-traded options and associated investments in stock.[4]

Improve Tax Treatment of Investment Hedges

Separately, in the context of tax reform for financial products, we would urge the Savings & Investment Working Group and the Finance Committee to consider proposals to ameliorate the harsh treatment of investment hedges under current law. Although current law has very sensible rules for business hedges that result in clear reflection of income from hedging transactions, the tax rules that apply to investment hedges are essentially anti-abuse rules that do not seek to clearly reflect income. The leading example is the straddle rules of Code section 1092, which can result in uneconomic, anti-taxpayer treatment of non-tax-motivated transactions.

Like the existing rules for business hedges, the application of a new hedge-timing regime for investment hedges should be elective and should require the taxpayer to identify the hedging transaction and the hedged position on the day the hedge is established. These features can readily be agreed upon. The challenge lies in developing appropriate timing rules for matching gains and losses on the hedging transaction and the hedged position that will result in a clear

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[4] For a more detailed exposition of our concerns regarding the mark-to-market proposals, see the comments filed by the Coalition with the Ways & Means Committee on April 22, 2013, available here: http://www.optionsclearing.com/components/docs/about/press/comment-letters/20130501-houseways_meanscommittee.pdf and the Coalition's letter to Assistant Secretary for Tax Policy Mark Mazur dated December 19, 2014, available here: http://www.optionsclearing.com/components/docs/about/press/comment-letters/20141219-ltr-to-mark-mazur-re-exchange-traded-options.pdf

reflection of income rather than anti-taxpayer loss deferral rules. We would welcome the opportunity to work with the Working Group and the Committee to develop an approach to investment hedges that, like the current-law approach to business hedges, would achieve a clear reflection of the taxpayer's income. Such a change would be a substantial improvement over current law.

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