U.S. Securities Markets Coalition
Comments on Senator Wyden's Discussion Draft of the
"Modernization of Derivatives Tax Act of 2016"

August 26, 2016

The members of the U.S. Securities Markets Coalition (the "Coalition")[1] welcome the opportunity to provide preliminary comments on the discussion draft of the Modernization of Derivatives Tax Act of 2016 (the "MODA Discussion Draft").

The Coalition applauds Senator Wyden's stated interest in creating "one fair system with simple and straightforward rules."[2] However, the Coalition respectfully believes that the MODA Discussion Draft would not advance these objectives, but instead would create results that are neither fair, nor simple, nor straightforward as applied to exchange-traded (i.e., listed) options.

Options have been traded on national securities exchanges in the U.S. for over 40 years, and the basic tax rules for exchange-traded options continue to work well for our millions of customers, and for the country as a whole. The Coalition believes that it is far better to "modernize" the taxation of derivatives, by identifying those specific areas where the rules fall short, and by providing limited guidance and reform in those specific areas. If Congress deems broad reform to be necessary, we strongly urge that exchange-traded options be excluded from the types of derivatives to which the MODA Discussion Draft would apply. Currently, the tax treatment of exchange-traded options is governed by well-established rules that are relatively simple and easy to understand. These rules were summarized in Revenue Ruling 78-182, not long after options first traded on a national securities exchange. These rules have worked well for decades, and we are aware of no significant concerns or uncertainties in their application. The fact that the rules are old, is no argument for replacing them, particularly when the options to which they apply are essentially the same as when the rules were promulgated. In this regard, exchange-traded options are not new or exotic instruments with troubling tax characteristics. All major tax policy goals – simplicity, fairness, efficiency and administrability – support retention of the current-law treatment of exchange-traded options over the approach set forth in the MODA Discussion Draft.

Broad-brush reform of the nature represented by the MODA Discussion Draft will create new, untold complexities, while at the same time, generating unfair results in many circumstances with regard to exchange-traded options. Of particular concern to the Coalition is

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[1] The members of the Coalition include all of the major options exchanges in the United States. 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 (OCC). All of these members are regulated by the Securities and Exchange Commission, and OCC is also regulated by the Commodity Futures Trading Commission and The Board of Governors of the Federal Reserve.

[2] Senator Wyden Statement of May 18, 2016, at http://www.finance.senate.gov/ranking-members-news/wyden-unveils-tax-proposal-to-build-a-fairer-system

that the MODA Discussion Draft would tax users of exchange-traded options with respect to "phantom income" in advance of their receipt of cash to pay tax, while at the same time effectively disallowing a tax deduction for economic losses. Furthermore, the MODA Discussion Draft would effectively impose a substantial, and needless, tax penalty on individuals and other taxpayers who commonly use exchange-traded options to reduce the risks of owning stocks or to generate additional income from their stock holdings. Such a tax penalty could include triggering gain on underlying stock that is not actually sold, as well as taxing gains from options transactions, while effectively disallowing a tax deduction for economic losses arising from options transactions. To illustrate the tax penalties inherent in the MODA Discussion Draft, consider the following example:

> **Example**. Assume an individual owns appreciated stock (worth $100) with a long-term holding period. If that taxpayer purchases a 30-day, exchange-traded put option on the stock (entitling her to sell the stock for $95)[3] to temporarily hedge against downside price risk, under the MODA Discussion Draft, the appreciated stock could be treated as sold on the date the taxpayer acquires the put option.[4] Assuming the stock is deemed sold, tax would be due at ordinary income

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[3] A put option gives the holder the right (but not the obligation) to sell specified property (e.g., stock) at a specified price ($95, in this example) over a specified period of time (30 days, in this example). In order to acquire a put option, the holder must pay a premium to the writer (or grantor) of the put option. The writer of a put option has the obligation to purchase the property from the holder at the specified price, if the holder exercises the option.

[4] To determine whether this result occurs, the MODA Discussion Draft requires the calculation of a complex correlation coefficient, which the draft calls "delta." Although a traditional measure of "delta" (i.e., one commonly used in the financial markets) would not trigger such a result in this Example, the definition of "delta" in the MODA Discussion Draft is unusual, and could trigger this result. At the very least, it involves large numbers of data sets and complex valuation techniques – hardly a simplification. Prop. Section 492(a)(1)(B)(1) would require the taxpayer to test whether the put option "has a delta with respect to [the stock] which is within the range beginning with minus 0.7 and ending with minus 1.0." Prop. Section 492(d) defines "delta" in a non-traditional and highly confusing way as "the ratio of the expected change in the fair market value of the derivative to any change in the fair market value of the [stock]" (emphasis added). Thus, upon acquiring the put option, the taxpayer must analyze the "expected change in the fair market value" of the put option (which itself requires complex Black-Scholes option pricing models involving inputs for "expected" volatility that may differ from person to person), in various hypothetical scenarios involving "any change" in the value of the stock. So, if one assumes that the underlying stock drops in value by one cent, then the "expected change in the fair market value" of the put option is not likely to increase by 0.7 of one cent. However, if one assumes that the underlying stock drops in value by $99, then the "expected change in the fair market value" of the put option is likely to increase by at least 0.7 of $99. In all likelihood, this latter scenario (i.e., a 99% decline in stock price over a 30 day period) is entirely unrealistic. Nevertheless, it would appear that the MODA Discussion Draft (which defines delta by reference to "any change" in the FMV of the stock, not to a specific increment of potential price change) would require the taxpayer to assume that this unrealistic scenario occurs, and to be taxed accordingly. We think that a system that bases taxation on unrealistic economic assumptions is inappropriate. Furthermore, even if the proposal's definition of "delta" is amended so that it conforms more closely to the market's conception of the idea, investors can (and do) calculate different deltas with respect to the same position – i.e., there is some level of subjectivity in the calculation. Thus, the statute will need to be precise in the manner in which it defines the concept, and regardless of how it does so, it will add complexity and confusion, because different taxpayers could calculate different deltas with respect to the same position (for purposes of their own investment decisions), but will still need to calculate the new "tax delta" (however defined).

rates on the built-in gain in the stock that is deemed to be sold.[5] This result follows, notwithstanding that if the taxpayer had actually sold the stock, the gain would be taxed at the preferential rates applicable to long term capital gains.

To make matters worse for the taxpayer (and from a tax policy perspective), whether the stock goes up or down in value over the 30-day term of the put option, she will face a serious, and unavoidable, "tax whipsaw":[6]

- If the stock goes up in value (from $100) during this 30-day period, the taxpayer will be taxed (again, at ordinary rates) on this appreciation when the put option expires; whereas the cost of the put option would (effectively) be non-deductible (forever).[7]
- If the stock goes down in value (from $100) during this 30-day period, this decline in value would also be recognized as a loss when the put option expires, but the loss is effectively (and permanently) non-deductible by the taxpayer; whereas any gain on the put option would be taxed as ordinary income.

Thus, in either scenario (<u>i.e.</u>, whether the stock goes up or down in value while the put option is outstanding), the taxpayer <u>will</u> be taxed on some amount of ordinary income without any offsetting deduction for true economic loss. The fact that this dynamic is exacerbated for taxpayers who are not astute enough to make tax-specific identifications is particularly troubling, especially if Congress intends the proposal to promote fairness and simplicity in administration.[8]

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[5] Prop. Section 491(b)(1)(A)(i) provides that any item of income recognized under Prop. Section 491(a) (which would include gain on the stock, in this example) is ordinary.

[6] This "whipsaw" occurs whether or not the taxpayer identifies the stock and the put option as an "investment hedging unit" under Prop. Section 492(c)(2). However, if the taxpayer fails to make such an identification or makes an election under Prop. Section 492(b), then Prop. Section 491(c)(2)(E) would deem a "taxable event" to occur on each business day during the 30-day period. This increases the potential magnitude of the harmful whipsaw to the taxpayer. (To see this most clearly, simply assume that the stock value went up and down on alternate business days – losses would be non-deductible, and gains fully taxed.)

[7] In this scenario, the put option would expire worthless. Section 67 limits the deduction for "miscellaneous itemized deductions." Such items are only deductible to the extent they exceed 2% of a taxpayer's adjusted gross income. In this case, because the put option premium would be an ordinary loss in the current year (under Prop. Section 491), it would be targeted by this limitation – effectively rendering the amount non-deductible in most cases when the taxpayer is an investor. See, section 165(a) & 165(c)(2) (granting deduction for losses incurred in transaction executed for profit, though not connected to trade or business); section 63(d) (defining "itemized deductions" to include deduction under section 165(a)); and section 67(b) (defining "miscellaneous itemized deductions" to include all itemized deductions, other than certain enumerated items which do not include the losses arising from the deemed sales arising from the MODA Discussion Draft).

[8] See footnote 6, *supra*.

Factually, this is a simple, and extremely common, example.[9] But it illustrates that the technical tax analysis under the MODA Discussion Draft is neither simple, nor fair, when applied to exchange-traded options executed by taxpayers who own the underlying stock.

In the same regard, we note that the MODA Discussion Draft does not eliminate the "straddle rules" of section 1092.[10] Instead, the proposal clearly envisions scenarios where a taxpayer might own stock and execute an option on that stock, and the combination simultaneously (i) does not meet the "delta test" of Prop. Section 492(d), and (ii) does constitute a straddle under section 1092. Indeed, by proposing to retain the straddle rules and repeal the "qualified covered call option" ("QCCO") exception to the straddle rules, the proposal clearly envisions scenarios in which covered call options do not fall within the proposed "investment hedging unit" ("IHU") regime, but do fall within the straddle regime.[11] Layering the IHU regime on top of the existing straddle regime does not simplify anything. Indeed, it represents a tremendous (and needless) increase in complexity.[12] Furthermore, it does not represent good tax or economic policy. From a tax policy perspective, non-IHU straddles are troubling because (in addition to the complexity) they would necessarily involve timing and character mismatches – the option would be marked-to-market as ordinary gain/loss;[13] whereas the stock would retain

[9] The unfavorable tax dynamics that are highlighted in the Example, above, are also present in other common situations in which a taxpayer may execute a listed option in combination with a stock position. For example, "covered call" transactions would also be targeted by the MODA Discussion Draft, such that (assuming the delta test is met) (i) built in gain (not loss) on an appreciated stock position would be realized (and taxed at ordinary rates) when the call option is first executed, and (ii) while the call option is outstanding, the taxpayer would be taxed on ordinary income without any deduction for economic losses.

[10] A tax "straddle" arises when an investor owns two offsetting, economic positions – i.e., one position "substantially diminishes the risk of loss" from holding the other. Broadly speaking, if a taxpayer executes a straddle, he/she is (i) prohibited from recognizing loss from one position to the extent there is unrecognized gain in the other position, (ii) unable to achieve a long-term holding period on the positions while the straddle is in place, and (iii) prohibited from deducting costs incurred to "carry" the positions.

[11] A call option gives the holder the right (but not the obligation) to purchase specified property (e.g., stock) at a specified price over a specified period of time. In order to acquire a call option, the holder must pay a premium to the writer (or grantor) of the call option. The writer of a call option has the obligation to sell the property to the holder of the call option at the specified price, if the holder exercises the call option. Individuals will frequently write (or sell) call options on stock that they hold, in order to generate additional income (in the form of premiums). This strategy is commonly referred to as writing or selling "covered call options." (The term stems from the idea is that the risk arising from having written the call option is "covered," by reason of the stock that the individual owns.)

[12] First, a taxpayer must test for "delta," and affirmatively identify (for tax purposes) that two positions do not meet the delta test. See Prop. Section 492(c)(2)(B). Then, the taxpayer must test for "substantial diminution of risk of loss" under section 1092, and decide when any special tax identifications or elections can or should be made under that regime. Thus, a taxpayer must constantly run two separate (and complicated) economic computations, and coordinate these computations with different "tax identification" regimes. Furthermore, assuming some positions fall into the IHU regime, and some fall into the straddle regime, the taxpayer must simultaneously apply both regimes. A taxpayer would still be required to monitor non-IHU straddles for tax attributes such as the loss deferral rule, potential loss of holding period, and expense capitalization.

[13] Losses would still be subject to the deferral rule. It is not clear how the identified straddle regime of section 1092(a)(2) would apply in this context.

realization-based accounting and capital character. From an economic policy perspective, repeal of the QCCO exception is problematic because it imposes a tax burden on an investment strategy widely regarded as helpful to investors and not tax motivated.[14]

The infirmities of the MODA Discussion Draft are not limited to situations like the ones above in which taxpayers execute exchange-traded options in combination with their stock positions. Even in situations where a taxpayer executes an exchange-traded option by itself (i.e., without any position in the stock underlying the option), the MODA Discussion Draft proposal will create unwarranted complexity and fairness issues. First, as noted above,[15] under the MODA Discussion Draft, all losses on exchange-traded options will effectively be non-deductible "miscellaneous itemized expenses" (because such expenses are subject to significant limitation). Prohibiting taxpayers from deducting economic losses on exchange-traded options, while at the same time taxing them on gains (at the taxpayer's highest marginal rate) is entirely unjustified. Second, while market values for actively traded exchange-traded options are readily observable, that is not necessarily true for thinly traded options. Options are exchange-traded 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).[16] 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, there may differences of opinion regarding a reasonable approximation of market value. We believe that conflict with the IRS regarding valuation will become commonplace. Thus, the MODA Discussion Draft will create serious burdens in administrability of the tax system. Imposing such burdens is needless. The current system works well, because (among other reasons) it accounts for taxpayers' income/loss from exchange-traded options when those amounts are certain, and not subject to valuation debates. (The current realization-based system also does not impose tax on "phantom income," that may never be earned because of market movements that occur in a subsequent tax year.) Moreover, marking exchange-traded options to market will result in a higher effective tax rate for exchange-traded options, as compared to stocks (which are not marked). Exchange-traded options will thus be "tax disadvantaged" relative to stocks (and short sales).[17] Instead, it

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[14] In 1984, Congress exempted QCCOs from the straddle regime because they are "undertak[en] primarily to enhance the taxpayer's investment return on the stock" and not to achieve an inappropriate tax benefit. See H.R. Rep. 98-432, 98th Cong., 2d Sess. At 1266-67 (1983). See also, Preamble to Notice of Proposed Rulemaking (REG-115560-99), 66 Fed. Reg. 4751 (Jan. 18, 2001) (noting Congress's determination that covered calls are written primarily to enhance a taxpayer's investment return.) Under the MODA Discussion Draft, it would appear that all covered call transactions will be subject to either the IHU regime, or the straddle regime (because holding a covered stock position will presumably substantially diminish risk of loss from issuing the call option).

[15] See footnote 7, *supra*.

[16] There are currently about 850,000 options "series" listed on U.S. options exchanges. Each series consists of a call option or a put option with a specific exercise price and a specific expiration date.

[17] See, David Weisbach, "A Partial Mark-to-Market System," 53 Tax L. Rev. 95, 100 (1999) (assets that are marked to market have higher effective tax rate than assets that are taxed based on realization principles; therefore, mark-to-market assets must have a lower nominal rate than realization assets in order to equalize effective tax rates). For this reason, we think it is problematic that the MODA Discussion Draft would repeal the "60/40 tax treatment" of section 1256. Section 1256 requires that certain listed options (generally broad-based index options that compete with futures contracts) be marked-to-marked, and that the resulting gain/loss be treated as 60% long-term gain/loss and 40% short-term gain/loss.

is entirely reasonable and appropriate to apply a lower nominal rate to assets that are marked-to-market, in order equalize the effective tax rate between realization-based assets and mark-to-market assets.

The Coalition would be happy to discuss these matters further with you. We hope this submission outlines in broad strokes the significant, and unfair, tax costs and complexities that the MODA Discussion Draft would impose on taxpayers who use exchange-traded options. These costs, in turn, would greatly harm the exchange-traded 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 MODA Discussion Draft 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.