U.S. Securities Markets Coalition

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U.S. Securities Markets Coalition
Comments on Senator Wyden's Proposed
"Modernization of Derivatives Tax Act of 2021"

September 17, 2021

The members of the U.S. Securities Markets Coalition (the "**Coalition**")[1] appreciate the opportunity to provide comments on Senator Wyden's proposed Modernization of Derivatives Tax Act of 2021 ("**MODA 2021**").[2] As you are aware, the Coalition has provided comments to prior drafts of this bill.[3] While certain changes have been made in response to our prior comments, we believe that, thus far, those changes are insufficient to protect investors in exchange traded options from severe tax consequences that are not in the best interest of investors, the capital markets or the country. We believe that MODA 2021 should not be adopted, because it has too many deficiencies and adverse consequences that have not been adequately considered or addressed. This letter suggests improvements that can be made to lessen those deficiencies, as they relate to exchange traded options. As described more fully below, this letter recommends that:

> (1) Exchange traded options should be excluded from the bill's 'mark-to-market' proposal.
>
> (2) Exchange traded options should be excluded from the bill's 'investment hedging unit' (or "**IHU**") proposal.

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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: the BOX Options Exchange, Cboe Options Exchange, Cboe C2 Options Exchange, Cboe BZX Options Exchange, Cboe EDGX 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] For the legislative text of the MODA 2021 proposal, see:
https://www.finance.senate.gov/imo/media/doc/Modernization%20of%20Derivatives%20Tax%20Act1.pdf

For an explanation of MODA 2021 prepared by the staff of the Joint Committee on Taxation, see:
https://www.jct.gov/publications/2021/jcx-34-21/

[3] The Coalition's prior comments to the MODA 2016 and MODA 2017 proposals are attached to this letter. They are entirely consistent with this letter (but certain points discussed in those comments have already been addressed).

(3) In the absence of such exclusions, the concept of 'delta' should be amended to more sensibly accommodate the manner in which the rules apply to exchange traded options.[4]

Recommendation #1 – Exclude Exchange traded Options from the 'mark-to-market' proposal.

The Coalition is concerned that MODA 2021 would tax users of exchange-traded options with respect to "phantom income" in advance of their receipt of cash to pay the tax. This reflects a dramatic departure from established tax norms, but does not deliver the significant simplification that the proposal promises. Even in situations where a taxpayer executes an exchange-traded option by itself (i.e., without any position in the stock underlying the option), MODA 2021 will create unwarranted complexity and fairness issues. 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 to market). Exchange-traded options will thus be "tax disadvantaged" relative to stocks.[5] Accordingly, in a world where derivatives are marked-to-market, it is entirely reasonable and appropriate to apply a lower nominal rate to such assets that are marked-to-market, in order to equalize the effective tax rate between realization-based assets and mark-to-market assets. As such, we urge that exchange traded options be excluded from the mark-to-market construct, as it will lead to considerable dislocation with other related assets.

Recommendation #2 – Exclude Exchange traded Options from the 'investment hedging unit' proposal.

MODA 2021's 'investment hedging unit' (or "**IHU**") proposal is complex and burdensome, and would also impose a substantial, and needless, tax penalty (i.e., triggering gain on underlying stock that is not actually sold) on individuals and other taxpayers who commonly

[4] More specifically, we believe that the computation of 'delta' of listed options should only take into account a balanced position – i.e., the amount of an underlying investment (the number of shares) that is referenced by the listed option itself.

[5] 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 MODA 2021 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-market, and that the resulting gain/loss be treated as 60% long-term gain/loss and 40% short-term gain/loss.

use exchange-traded options to reduce the risks of owning stocks or to generate additional income from their stock holdings. To illustrate the difficulties inherent in MODA 2021, as it relates to exchange-traded options executed in combination with underlying stock positions, consider the following simplified example of a standard "protective put option" [6] strategy.

> **Base case example**.[7] Individual owns 500 shares of XYZ Corp stock (a publicly traded corporation). These 500 shares were acquired at different times and have different cost basis. Some of the shares have built-in capital gain, and some have built-in capital loss, with different holding periods.
>
> Shares of XYZ Corp are trading at $100 per share – i.e., individual's total position in XYZ Corp stock is worth $50,000.
>
> Individual wants to temporarily protect herself with respect to a decline in value of a portion (100 shares) of her holdings. Therefore, individual purchases a single, 30-day, exchange-traded put option with respect to 100 shares of XYZ Corp stock. The put option has a strike price of $95 per share (i.e., the individual has the option to sell 100 shares of XYZ stock for $9500). (Because XYZ stock is trading at $100 per share, the put option is "out of the money.")
>
> Assume individual paid a $50 premium to acquire the put option.[8]
>
> Assume the value of XYZ Corp stock declines by $1 (from $100 to $99 per share). Following this decline in XYZ Corp stock value:
>
>> Individual's total XYZ Corp holdings are worth $49,500. They have declined in value by $500. (If one only focuses on 100 shares, those 100 shares have declined in value by $100.)
>>
>> The put option (originally purchased for $50) increases in value as a result of the decline in value of XYZ Corp stock. (A put option to sell for $95 is worth more when the stock is worth $99 than when it is worth $100.) Assume the value of the put option is $60 following the decline in XYZ

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[6] A put option gives the holder the right (but not the obligation) to sell specified property (e.g., 100 shares of stock, in this example) 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. In the example outlined above, the taxpayer buys a "protective put option" (so-named because the taxpayer is using the put option to protect her investment). This investment strategy has always been a very common technique for investors seeking to protect themselves from volatility – it has nothing to do with tax abuse.

[7] The facts in this 'base case example' will be used in the discussions of both Recommendation 2 and Recommendation 3.

[8] We can provide actual values of actual put options. The option values are simplified here for illustrative purposes.

Corp stock value. Therefore, the put option has increased in value by $10.[9]

Under MODA 2021, in order to determine her tax liability, the taxpayer must calculate the "delta" with respect to the put option relative to the XYZ Corp stock. However, MODA 2021 actually computes delta by affirmatively testing on an **<u>unbalanced</u>** basis. Proposed Section 492(a)(3)(A)(i) would compute delta by comparing: "the derivative by itself … with respect to **<u>any portion</u>** of such underlying investment." (emphasis added) (See also, commentary and example on page 23 of the JCT report.)

As a result of this rule, in the base case example outlined above, one must compute "delta" by comparing the **<u>unbalanced</u>** positions of:

> (x) the put option on <u>100 shares</u> (which increases by $10 if the stock declines in value by $1 per share), to
>
> (y) <u>10 shares</u> (not 100 shares) of stock held by the taxpayer (which decreases by $10 if the stock declines in value by $1 per share),

Calculated in this manner, in the base case example, the put option would have a "delta" of negative 1.0 with respect to 10 shares of stock. (As 10 shares decrease by $10 ($1 per share), the put option increases in value by $10.) This is within the range of Proposed Section 492 to establish an IHU with respect to 10 shares of the taxpayer's XYZ Corp stock.

This result is counterintuitive, because it does not comport with economic reality. Most disturbingly, the tax consequences can be **<u>severe</u>**. First, if the taxpayer does not affirmatively identify which 10 shares are part of an IHU with respect to the put option, then she is deemed to have made an election under Proposed Section 492(b)(1) (see Proposed Section 492(b)(3)) – such that taxpayer must mark-to-market **<u>all</u>** 500 shares of XYZ Corp stock (recognizing any built-in gains, but no built-in losses). Second, the taxpayer would be required to mark-to-market any and all shares of XYZ Corp stock in perpetuity (or until the election is revoked by the Secretary), regardless of when those shares are acquired. We would not expect taxpayers to be in a position to avoid this perverse result by calculating delta and identifying the 10 shares comprising the IHU on a timely basis. We also are concerned that the taxpayer would not have the funds to pay this tax, because she is not actually selling her underlying equity position. Therefore, we are concerned that the taxpayer will simply refrain from attempting to manage risk by executing put options in the first place (rather than risk the IRS establishing this result 'after the fact').

Even if the taxpayer does (i) "spot the issue," (ii) perform the complex delta calculation, and (iii) identify the 10 shares that are subject to the put option (each of which is immensely complex), the taxpayer must mark-to-market 10 shares of XYZ Corp stock. We do not think the taxpayer should be required to recognize the gain with respect to even 10 shares. The taxpayer has partially (and temporarily) diminished risk of 100 shares, not entirely reduced risk of 10 shares. We recognize that Proposed Section 491(b)(3)(B) allows the taxpayer to identify **<u>which</u>**

[9] Id.

10 shares are part of the IHU, and (on the current facts) this allows a taxpayer to identify the put option with built-in loss shares. But this will not always be the case (because some taxpayers may only have shares with built-in gain). Regardless, this requires the taxpayer to forever track which stock positions have been part of an IHU. The tracking gets even more unwieldy if the taxpayer were to execute many different put options over a sustained period of time.

We also note that, factually, this is a simple, and extremely common, example – a simple "protective put" option. But it illustrates that the technical tax analysis under MODA 2021 is neither simple, nor straightforward, nor fair, when applied to exchange-traded options executed by taxpayers who own the underlying stock. Consider that the calculation of delta, in respect of exchange traded options, requires a complex Black-Scholes valuations in addition to a complex correlation calculation. This type of calculation is hardly a simplification to the tax code, and will create enormous confusion for retail investors, who will be incapable of computing delta in "real time" in order to make reduce the severe tax consequences. These investors will either refrain from executing options altogether, or will be forced by the IRS to mark-to-market their stock positions in perpetuity.

Furthermore, we note that some sophisticated investors can (and do) calculate different deltas[10] 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). Having said that, many taxpayers do not calculate delta at all, and/or will simply be incapable of calculating it on their own.

We recognize that Proposed Section 492(a)(3)(B) provides: "The Secretary may prescribe regulations or other guidance to modify the rules [of section 492(a)(3)(A)] to simplify the application of such rules to [exchange traded options]." We believe this provision confirms that the exchange traded options are meant to be tested on an unbalanced balance, and simply authorizes Treasury to "simplify" the process. The provision correctly recognizes that the application of the rules to exchange traded options is complex. However, we believe the proper solution is to entirely exclude exchange traded options from the IHU regime, or (consistent with our Recommendation #3) remove most exchange traded options from this complexity by testing exchange traded options on a "balanced basis," comparing the value of the exchange traded options to the number of shares underlying the option itself. As written, the provision "kicks the can" down the road to Treasury to promulgate rules after significant harm has already been sustained by the options market. We would observe that the failure of Treasury to promulgate rules relating to many financial products (not exchange traded options) led to the MODA proposal in the first place. Rather than leaving responsibility to Treasury to craft a more "simplified" approach for exchange traded options, Congress should address the deficiencies head on, by removing exchange trade options from the IHU regime.

[10] It should also be noted that options themselves are valued differently by different investors. The valuation of options requires complex Black-Scholes option pricing models involving inputs for "expected" volatility that may differ from person to person.

<u>Recommendation #3 – More sensibly define 'delta' with respect to exchange traded options</u>.

In the absence of a complete exclusion from the IHU regime, the Coalition believes that a more sensible approach with respect to exchange traded options, would involve a computation of delta by reference to balanced positions – <u>i.e.</u>, comparing (a) the value changes of the put option, with (b) the value changes of the same/balanced number of shares as covered by the put option.

In respect of the "base case example" discussed above, if one computes "delta" by comparing the <u>balanced</u> positions of:

> (x) the put option on <u>100 shares</u> (which increases by $10 if the stock declines in value by $1 per share), to
>
> (y) <u>100 shares</u> of stock held by the taxpayer (which decreases by $100 if the stock declines in value by $1 per share),

then the put option would have a "delta" of negative 0.1 with respect to 100 shares of stock. (As shares decrease by $100, the put option increases in value by $10.) This is well outside the range of Proposed Section 492 to establish an IHU.

This comports with the investor's expectations. She has only diminished risk of loss with respect to 100 shares. (A put option is not typically regarded as a "delta 1 derivative" for this very reason.) Recognizing this, under current law, she would have created a "straddle" (under section 1092) with respect to 100 shares, but not a constructive sale (under section 1259) with respect to any shares. In fact, this "balanced approach" is consistent with established administrative practice of the IRS, as effectively ratified by Congress in 2004.[11] Therefore, in the absence of an exclusion of exchange traded options from the IHU regime, we believe the following provision should be included in MODA 2021:

> "For purposes of computing 'delta' with respect to a listed option, the computation shall be performed by comparing the fair market value of the

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[11] Before its amendment in 2004, section 1092(c)(2)(B) authorized the Treasury to promulgate regulations with respect to straddles when one side was larger than the other. No regulations were ever issued, but administratively, the IRS allowed taxpayers to identify straddles in a balanced fashion. See, e.g., PLR 199925044. Thus, if a taxpayer owned 200 shares, and purchased a put option on 100 shares, the taxpayer could identify the put option as a straddle with respect to 100 shares, without fear that the remaining 100 shares would be included in the straddle. The amendments to the identified straddle regime in 2004 essentially approved of this approach – the put option on 100 shares could be identified to 100 shares (without fear that some portion of the remaining 100 shares would be considered "part of a larger straddle," and thus ruining the election/identification). This demonstrates an administrative practice of respecting "balanced positions" and not seeking to impose a punitive regime by testing unbalanced positions for tax purposes. Congress explicitly considered this approach in 2004, and did not register any objection to the approach. See Joint Committee on Taxation "Bluebook" with respect to the 2004 American Jobs Creation Act, p.482 (specifically discussing unbalanced straddles and the IRS ruling which allowed taxpayer to apply the rules on a balanced basis).

> listed option to the same amount (e.g., number of shares) of the underlying asset that is specifically referenced by the listed option."

Furthermore, as noted above, the computation of delta is exceptionally complex. If it is to be retained, we think it is important that taxpayers be able to rely on others' computation of delta, if that computation is being performed for non-tax regulatory purposes. In the case of exchange traded options, the Options Clearing Corporation (OCC) computes option delta on a daily basis and provides this data to trading firms/brokers so that they can comply with certain "position limits" imposed by the SEC.[12] (The SEC has examined these delta calculations to ensure that they correctly measure risk and appropriate position limits.) We believe that this calculation should be more than sufficient for tax purposes. Therefore, the Coalition recommends that the following provisions should also be included in MODA 2021:

> "If a taxpayer independently calculates delta for non-tax business purposes, that delta ordinarily is the delta used for purposes of this section. Notwithstanding the preceding sentence, if a taxpayer's broker calculates delta, or relies on another person's calculation of delta, in order to comply with non-tax laws or regulations of the United States (including, for this purpose, in order to comply with the rules of a regulated exchange), then such taxpayer is entitled to rely on this computation of delta for purposes of this section."

> "The delta of a listed option is the delta of that option at the close of business on the business day immediately preceding the date that the tested option contract is executed. On the date an option contract is listed for the first time, the delta is the delta of that option at the close of business on the date of listing."

Conclusion. The Coalition would be happy to discuss these recommendations further with you. We hope this submission outlines in broad strokes the significant, and unfair, tax costs and complexities that MODA 2021 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, MODA 2021 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. Broad-brush reform of the nature represented by MODA 2021 will create new, untold complexities, while at the same time,

[12] For a brief discussion of delta position limits and the data that OCC calculates and provides, see: https://www.theocc.com/Clearance-and-Settlement/Industry-Services. See also: https://www.theocc.com/getmedia/63b34fce-8b84-4161-80d6-7381013cbf2d/ENCORE_DDS_Guide_Delta_Position_Limits.pdf.

generating unfair results in many circumstances with regard to exchange-traded options which are not tax avoidance transactions.

ATTACHMENTS:

APPENDIX A – Coalition Comment Letter with respect to MODA 2017

APPENDIX B – Coalition Comment Letter with respect to MODA 2016

Appendix A

U.S. Securities Markets Coalition
Comments on Senator Wyden's Discussion Draft of the
"Modernization of Derivatives Tax Act of 2017"

July 14, 2017

The members of the U.S. Securities Markets Coalition (the "**Coalition**")[1] welcome the opportunity to provide comments on Senator Wyden's proposed Modernization of Derivatives Tax Act of 2017 ("**MODA 2017**").[2] The Coalition applauds Senator Wyden's stated interest in "radically simplifying" the tax code to create "a simpler, more straightforward tax regime."[3] However, the Coalition respectfully believes that MODA 2017 would not advance this objective, but instead would create results that are neither simple, nor straightforward, nor fair, 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 MODA 2017 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 MODA 2017.

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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] MODA 2017 was introduced by Senator Wyden on May 2, 2017, as S. 1005. Legislative text of the bill can be found at:
https://www.finance.senate.gov/imo/media/doc/S.%201005_Modernization%20of%20Derivatives%20Tax%20Act%20TEXT%20(FRA17032).pdf

[3] See Senator Wyden's statement of May 2, 2017, at:
https://www.finance.senate.gov/imo/media/doc/MODA%20Section-by-Section%202017.pdf

Broad-brush reform of the nature represented by MODA 2017 will create new, untold complexities, while at the same time, generating unfair results in many circumstances with regard to exchange-traded options.

First, the Coalition is concerned that MODA 2017 would tax users of exchange-traded options with respect to "phantom income" in advance of their receipt of cash to pay tax. This reflects a dramatic departure from established tax norms, but does not reflect the dramatic simplification that the proposal promises. Even in situations where a taxpayer executes an exchange-traded option by itself (i.e., without any position in the stock underlying the option), MODA 2017 will create unwarranted complexity and fairness issues. 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).[4] 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 be differences of opinion regarding a reasonable approximation of market value. We believe that conflict with the IRS regarding valuation will become commonplace. Thus, MODA 2017 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).[5] Accordingly, in a world where derivatives are marked-to-market, it is entirely reasonable and appropriate to apply a lower nominal rate to such assets that are marked-to-market, in order to equalize the effective tax rate between realization-based assets and mark-to-market assets.

Second, and perhaps even more concerning to the Coalition, is that MODA 2017 would (A) impose a substantial, and needless, tax penalty (i.e., triggering gain on underlying stock that is not actually sold) 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; and (B) create a tremendous amount of administrative and legal complexity (thereby failing to achieve the proposal's stated goals). To illustrate the difficulties inherent in MODA

[4] 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.

[5] 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 MODA 2017 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.

2017, as it relates to exchange-traded options executed in combination with underlying stock positions, consider the following example:

Base Case Example. Assume an individual taxpayer owns 100 shares of appreciated stock, worth $100 per share ($10,000 total). In order to temporarily hedge against downside price risk, the taxpayer purchases a single, 30-day, exchange-traded put option on the stock, entitling her to sell 100 shares of the stock for $95 per share (or $9,500 total).[6]

Hypothetical #1 (Small Price Change to Stock). Assume the stock depreciates in value by $1 per share (such that the taxpayer's total, 100-share stock investment depreciates by $100). We will call this hypothetical stock movement, a "**Small Price Change**." In the event of a Small Price Change, the put option on 100 shares might be expected to increase in value by $50.

Testing for Delta on Balanced Positions. If one considers only Small Price Changes[7] and compares the balanced positions of (x) the put option on 100 shares (which increases in value by $50 if the stock declines by $1 per share), to (y) the 100 shares owned by the taxpayer (which decreases in value by $100 if the stock declines by $1 per share), then the put option would have a "delta" of negative 0.5 – outside the range of Proposed Section 492 to establish an "investment hedging unit" or "IHU."[8]

Testing for Delta Using Lopsided Positions. However, if one only considers Small Price Changes, but compares the lopsided positions of (x) the put option on 100 shares (which increases in value by $50 if the stock declines by $1 per share), to (y) only 50 shares owned by the taxpayer (which decreases in value by $50 if the stock declines by $1 per share), then the put option would have a "delta" of negative 1.0 – and the taxpayer would be said to have

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[6] A put option gives the holder the right (but not the obligation) to sell specified property (e.g., 100 shares of stock, in this example) 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. In the example outlined above, the taxpayer buys a "protective put option" (so-named because the taxpayer is using the put option to protect her investment). This investment strategy has always been a very common technique for investors seeking to protect themselves from volatility – it has nothing to do with tax abuse.

[7] In contrast to a Dramatic Price Change, described below.

[8] This result follows because, as the 100 shares go down by $100 in value, the put option on 100 shares goes up by $50 in value.

created an IHU on 50 shares.[9] As a result, under MODA 2017, the taxpayer triggers built-in gain with respect to 50 shares of stock.[10]

Hypothetical #2 (Dramatic Price Change to Stock). Assume the stock depreciates in value by $95 per share (such that the taxpayer's total, 100-share stock investment depreciates by $9,500). We will call this hypothetical stock movement, a "**Dramatic Price Change**." In the event of a Dramatic Price Change, the put option on 100 shares might be expected to increase in value by close to $9,500. Thus, even if one only considers balanced positions (<u>i.e.</u>, 100 shares relative to a put option on 100 shares), testing the delta by reference to a Dramatic Price Change (albeit an unlikely one) would result in a "delta" close to negative 1.0, thus establishing an IHU, and causing the taxpayer to recognize built-in gains on her entire stock position (<u>i.e.</u>, all 100 shares).

Factually, this is a simple, and extremely common, example – a simple "protective put" option. But it illustrates that the technical tax analysis under MODA 2017 is neither simple, nor straightforward, nor fair, when applied to exchange-traded options executed by taxpayers who own the underlying stock. We hope the example illustrates the following points:

- Proposed 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 <u>any change</u> in the fair market value of the [stock]" (emphasis added). By testing for delta by reference to "any change" in the value of the underlying stock, the proposal suggests that even Dramatic Price Changes must be considered and tested. This unrealistic assumption could result in nearly every option creating an IHU with respect to underlying stock, notwithstanding that Dramatic Price Changes are unrealistic. We think that a system that bases taxation on unrealistic economic assumptions is inappropriate. We would also observe that recently promulgated Treasury Regulations under section 871(m) do not define delta in the same manner as MODA 2017. We have attached a definition of delta that conforms more closely to the section 871(m) regulations, and to market participants' understanding of the concept. See Appendix A.

- Even if the proposal's definition of "delta" is amended so that it conforms more closely to the market's conception of the idea (<u>i.e.</u>, with respect to Small Price Changes, and not Dramatic Price Changes), some investors can (and do) calculate different deltas[11] with respect to the same position – <u>i.e.</u>, there is some level of

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[9] This result follows because, as the 50 shares go down by $50 in value, the put option on 100 shares goes up by $50 in value.

[10] It is not clear which shares are involved in this deemed sale – the shares with the highest or lowest basis? Or the shares with the longest or shortest holding period?

[11] It should also be noted, that options themselves are valued differently by different investors. The valuation of options requires complex Black-Scholes option pricing models involving inputs for "expected" volatility that may differ from person to person.

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). Having said that, many taxpayers do not calculate delta at all, and/or will simply be incapable of calculating it on their own. Consider that the calculation of delta, in respect of listed options, requires complex Black-Scholes valuations in addition to a complex correlation calculation. This type of calculation is hardly a simplification to the tax code. Thus, if the concept of delta is to be retained in the tax law, we think it is important that taxpayers be able to rely on others' computation of delta, if that computation is being performed for non-tax regulatory purposes. We have included this idea in our proposed definition of delta. See Appendix A.

- Proposed Section 492(a)(3)[12] would affirmatively create lopsided IHUs from otherwise balanced positions. In the example above, the taxpayer may think that she has partially managed downside risk in respect of 100 shares of stock by purchasing a put option on 100 shares, but MODA 2017 would instead dictate that she has eliminated all risk/reward in respect of 50 shares of stock, by purchasing a put option on 100 shares. Simply put, this is a bad idea. It does not comport with investors' expectations when executing the transaction, and it imposes a tax penalty in an extremely counterintuitive manner. In fact, it runs contrary to established administrative practice of the IRS.[13] Furthermore, it adds a tremendous amount of computational complexity.

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 MODA 2017 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, MODA 2017 would distort

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[12] This provision was not included in Senator Wyden's 2016 MODA Discussion Draft.

[13] Before its amendment in 2004, section 1092(c)(2)(B) authorized the Treasury to promulgate regulations with respect to straddles when one side was larger than the other. No regulations were ever issued, but administratively, the IRS allowed taxpayers to identify straddles in a balanced fashion. See, e.g., PLR 199925044. Thus, if a taxpayer owned 200 shares, and purchased a put option on 100 shares, the taxpayer could identify the put option as a straddle with respect to 100 shares, without fear that the remaining 100 shares would be included in the straddle. The amendments to the identified straddle regime in 2004 essentially approved of this approach – the put option on 100 shares could be identified to 100 shares (without fear that some portion of the remaining 100 shares would be considered "part of a larger straddle," and thus ruining the election/identification). This demonstrates an administrative practice of respecting "balanced positions" and not seeking to impose a punitive regime by testing unbalanced positions for tax purposes.

economic decision-making and replace the well-established and relatively simple tax rules for options with a harsh, burdensome and overly complicated regime.

APPENDIX A

Delta Generally. For purposes of this section, the term ‘delta’ means, with respect to a derivative and an underlying asset, the ratio of the change in the fair market value of the derivative to a small change in the fair market value of the same amount (e.g., number of shares) of the underlying asset that is referenced by the derivative. If a taxpayer independently calculates delta for non-tax business purposes, that delta ordinarily is the delta used for purposes of this section. Notwithstanding the preceding sentence, if a taxpayer’s broker calculates delta, or relies on another person’s calculation of delta, in order to comply with non-tax laws or regulations of the United States (including, for this purpose, in order to comply with the rules of a regulated exchange, as defined below), then such taxpayer is entitled to rely on this computation of delta for purposes of this section.

Delta Calculation for Listed Options.

In general. The delta of an option contract that is listed and available for trading on a ‘regulated exchange’ (defined below) is the delta of that option at the close of business on the business day immediately preceding the date that the tested option contract is executed. On the date an option contract is listed for the first time, the delta is the delta of that option at the close of business on the date of listing.

Regulated Exchange. For purposes of this section, a ‘regulated exchange’ is any exchange that is either:

(A) A national securities exchange that is registered with the Securities and Exchange Commission; or

(B) A foreign securities exchange that is designated as a ‘regulated exchange’ for purposes of this section by the Secretary, via regulation or administrative guidance.

Appendix B

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

[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

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[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.