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March 5, 2014

Hon. John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

Re: Proposed Regulations Under Section 871(m) (REG-120282-10)

Dear Commissioner Koskinen:

This letter sets forth comments on proposed regulations issued under section 871(m)¹ relating to the imposition of U.S. withholding tax on “dividend equivalents” paid pursuant to certain notional principal contracts (“NPCs”) and other equity-linked instruments referencing U.S. equities. These comments are submitted on behalf of the U.S. Securities Markets Coalition (the “Coalition”), the members of which include all of the options exchanges in the United States and the Options Clearing Corporation (“OCC”).² Options trading on these exchanges for 2013 exceeded four billion contracts with respect to some 3,700 individual equities as well as various equity indexes.

The Coalition is very concerned about the application of the proposed regulations to exchange-traded options (also referred to as “listed options”). The proposed regulations, if

¹ Unless otherwise indicated, all references to sections are to sections of the Internal Revenue code of 1986, as amended, or to the regulations thereunder.

² The members of the Coalition are BATS Options, the Boston Options Exchange, the Chicago Board Options Exchange, the International Securities Exchange, NASDAQ Options Market, NASDAQ OMX PHLX, NYSE Arca, NYSE Amex, and OCC.

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adopted as final, would apply much more broadly than intended by Congress and would have a disruptive effect on the U.S. options markets. They would treat all options transactions with initial “deltas” of 70 or higher as economic substitutes for owning the underlying stock even though the risks and rewards associated with such options deviate significantly from those associated with owning the stock. A rational foreign person would enter an options position to avoid withholding tax on a dividend only if the options position will result in a better risk-adjusted, after-tax return. Given that dividend withholding tax typically represents only a very small percentage of a stock’s value, it is highly unlikely that a foreign person would assume the risks associated with a delta-70 option to avoid withholding tax.

In determining the delta of a transaction involving multiple options positions, the proposed regulations disregard the economics of the transaction by looking only to options with positive deltas and ignoring those with negative deltas. The proposed regulations would thus sweep in many popular options strategies, such as call spreads, that have highly nonlinear pay-offs characteristic of options and are plainly not substitutes for owning the underlying stock.

The proposed regulations would require brokers to develop systems to identify options transactions with an initial delta of 70 or higher. Since the delta of an option is closely tied to the trading price of a stock, brokers will need to use the trading price of the underlying stock at the time of day the option is entered into to determine the option’s delta. Identical options entered into by a customer on different days -- or at different times on the same day -- will have different initial deltas depending on the stock price at the time the option is entered into, and brokers’ systems will need to be able to distinguish those with initial deltas of 70 or higher from those with lower deltas. Brokers’ systems will also need to calculate an option’s delta when a dividend on the underlying stock is paid and when an option is terminated. The Coalition is concerned that brokers may be unwilling to bear the costs of developing and maintaining such systems and will preclude their foreign customers from trading listed options or otherwise restrict the types of options transactions they may enter. Even if brokers are willing to develop the necessary

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systems, they are likely to pass the costs on to their foreign customers who trade options, which will increase the cost of trading options.

As explained more fully below, the Coalition recommends the following changes to the proposed regulations: (i) options should not be covered unless they have an initial delta of at least 90 or 95; (ii) the deltas of options that expose the foreign person to similar risks (such as two delta 50 call options) should not be combined; (iii) the deltas of call spreads and other options transactions involving multiple options positions should be determined on a net basis; (iv) safe harbors and other rules should be added to reduce the extraordinary burden on brokers and other market participants; (v) expected dividends that have not yet been declared should not be treated as dividend equivalents; and (vi) broad-based indexes (as defined under the securities laws) on which listed options and futures are traded should be “qualified indexes” and exchange-traded funds (“ETFs”) that track such indexes should be treated similarly.

The balance of this letter is organized as follows: Part I provides background information on listed options. Part II describes the proposed regulations, with a particular focus on aspects of the proposed regulations that relate to options transactions. Part III describes the Coalition’s concerns regarding the application of the proposed regulations to listed options. Part IV sets out the Coalition’s recommendations for revising the regulations.

I. Exchange-traded Options

U.S. options exchanges offer options on individual equities and options on equity (and equity-related) indexes. OCC provides central counterparty clearing and settlement services to all the U.S. options exchanges and is the world’s largest equity derivatives clearing organization. Listed options are traded on 3,700 different stocks and equity-based indexes. In 2013, some 3.7 billion options contracts on individual equities were traded on U.S. options exchanges, with each contract covering 100 shares of the underlying stock. Taking into account index options, 4.1

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billion options contracts were traded on U.S. options exchanges in 2013, or an average of 16.3 million contracts per trading day.

As with markets for publicly traded stock, bid and ask prices are quoted for listed options. In a typical transaction, a person wishing to purchase an option places an order with his or her broker. If the order is a “market” order, the order is filled at the best price being offered on any of the U.S. exchanges on which the specific option is traded. The exchange on which the transaction occurs matches the customer’s order with a seller posting the best offer and sends the matched trade to OCC. The OCC clearing member representing the option buyer and the OCC clearing member representing the option seller settle the transaction through OCC. The option contract is then “novated,” with OCC becoming the counterparty to the clearing member representing the option buyer and the counterparty to the clearing member representing the option seller. There is no continuing relationship between the option buyer and the option seller who were originally “matched.”

This arrangement continues until one of three things occurs: (i) the option expires, (ii) the holder or the writer of the option enters into a closing transaction to terminate the contract,³ or (iii) the holder exercises the option. Based on OCC statistics for 2013, 20.5% of all listed option transactions expired without being exercised, 72.5% were terminated through closing transactions, and 7% were exercised. Under OCC rules, any equity option that is “in the money” immediately prior to expiration is automatically exercised unless OCC has received contrary instructions from the clearing firm that holds the option.

Some options strategies entail buying or writing a single option, such as buying a 30-day call option on 100 shares of Intel with a strike price of \$25, or multiple identical option contracts,

³ A closing transaction by one of the original parties to the contract has no effect on the position of the other original party to the contract. For example, if the buyer of a call option closes out his or her contract, the written option by the original seller of the option remains in place.

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such as buying ten 30-day call options on a total of 1,000 shares of Intel with a strike price of \$25. Other options strategies involve multiple options with differing terms. One very common strategy (or group of strategies) is known as a “spread.” For example, a “bull call spread” consists of a purchased call with one strike price and a written call with higher strike price. Spreads take many forms: In addition to bull call spreads like those just described, there are bear call spreads, bull and bear put spreads, calendar spreads and back spreads. Other strategies including multiple option positions include put-call combinations, butterflies, condors, straddles and strangles. With the exception of put-call combinations, these strategies typically involve both options with positive deltas and options with negative deltas. Spreads and other strategies are typically entered into as a single transaction (through what is known as a “complex order”), and represent a significant portion of all trading volume. For example, in 2013, over 25% of all options contracts traded on the Chicago Board Options Exchange (“CBOE”) were spreads entered into as a single transaction. Options traders frequently modify the positions of these strategies over time.

Under OCC rules, the terms of outstanding options contracts are modified when the issuer of the underlying stock declares a special dividend.⁴ The adjustment for a special dividend typically consists of reducing the strike price of the option by the amount of the special dividend, with the adjustment taking effect on the ex-dividend date. For example, if Google declared a \$15 special dividend, the strike price for outstanding Google options would be reduced by \$15, effective on the ex-dividend date.⁵ Strike prices of listed options are not adjusted to reflect regular dividends.

⁴ As a general rule, no adjustment is made for a special dividend unless it is at least \$0.125 per share (which equates to \$12.50 per options contract).

⁵ Adjustments to take account of special dividends (and other corporate actions such as stock splits) are made to protect the expectations of market participants and to permit the options market to function smoothly. If such adjustments were not made, one party would receive a windfall and the other would suffer an unfair loss.

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II. The Proposed Regulations

The proposed regulations (the “2013 Proposed Regulations”) replace proposed regulations issued in January of 2012 (the “2012 Proposed Regulations”). Under the 2012 Proposed Regulations, an equity swap transaction would be subject to section 871(m) (a “specified NPC”) if it had any of seven characteristics. As with the four characteristics listed in section 871(m) itself that cause a swap to be a specified NPC, the seven characteristics represented an attempt to distinguish swaps with a potential for tax avoidance (“bad swaps”) from swaps that did not have a potential for tax avoidance (“good swaps”). The 2012 Proposed Regulations used these same seven characteristics to identify options and other equity-linked instruments (“ELIs”) that would be subject to section 871(m) (“specified ELIs”). The Coalition filed comments on the 2012 Proposed Regulations recommending, *inter alia*, that coverage of options should be limited to options that are “delta one” instruments and that the characteristics that cause an option to be a section 871(m) transaction should take into account the differences between options and equity swaps.⁶

The 2013 Proposed Regulations abandon the approach of listing multiple characteristics to distinguish “bad swaps” from “good swaps.” Instead, the 2013 Proposed Regulations adopt a single-factor test for identifying section 871(m) transactions (*i.e.*, specified NPCs and specified ELIs): Any NPC or ELI with a delta of 70⁷ or higher when entered into will be a specified NPC or specified ELI. Thus, if a dividend equivalent payment (as broadly defined by the 2013 Proposed Regulations) is made with respect to such an NPC or ELI, including a listed option, the section 871(m) withholding tax will apply.

⁶ A copy of the Coalition’s April 6, 2012, comment letter on the 2012 Proposed Regulations is available at: <http://www.regulations.gov/#!documentDetail;D=IRS-2012-0002-0013>.

⁷ The 2013 Proposed Regulations use “.70” instead of “70,” but the terms are equivalent.

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The single-factor, delta-based approach in the 2013 Proposed Regulations is based on a broader interpretation of “potential for tax avoidance” than the interpretation underlying the 2012 Proposed Regulations. Under the 2013 Proposed Regulations, it is enough that a swap or other derivative approximates the economics of owning the stock; no facts indicating that the foreign person may be motivated by a desire to avoid dividend withholding tax or that the counterparty could be viewed as acting as an agent are necessary. The preamble of the 2013 Proposed Regulations explains the basis for the new interpretation as follows:

A transaction has the “potential for tax avoidance” if it approximates the economics of owning an underlying security without incurring the tax liability associated with owning that security. In many cases, a long party is indifferent as to whether to invest in a derivative or a physical position because the derivative and the physical position provide comparable economic returns. . . . When dividends paid on physical securities are subject to tax while dividend equivalents with respect to economically comparable derivatives are not, those derivatives have a potential for tax avoidance regardless of whether a long party is using the derivative in a particular case to avoid tax. Accordingly, the Treasury Department and the IRS favor a delta approach that objectively identifies transactions in which the long party is able to sufficiently approximate the economic returns associated with an underlying security.

The 2013 Proposed Regulations include the following rules relating to the determination of delta:

- Delta is defined as “the ratio of the change in the fair market value of an NPC or ELI to the change in the fair market value of the property referenced by the NPC or ELI.”
- Delta must be determined in a commercially reasonable manner.

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- If an NPC or ELI has an initial delta of 70 or greater, it is not retested later to determine if the delta remains at 70 or above. Thus, an option with an initial delta of 70 remains a specified ELI even if its delta drops to 50 or below.⁸ Similarly, an option with an initial delta of less than 70 does not become a specified ELI if its delta later increases to 70 or above.
- Multiple transactions referencing the same underlying stock are treated as a single transaction for purposes of determining whether section 871(m) applies if the transactions are entered into “in connection with” each other. The examples in the 2013 Proposed Regulations⁹ make clear that when this standard is met, the deltas of the combined transactions are added together to determine if the delta 70 standard is satisfied. Thus, if a foreign person buys a 40 delta call and writes a 30 delta put on the same stock, and the transactions are “in connection with” each other, the two transactions are treated as a single transaction with a delta of 70. This rule also applies if a party related to the taxpayer enters into one of the transactions, as long as the “in connection with” standard is met.
- When one transaction is entered into in connection with a transaction that was entered into on an earlier date, the deltas of both transactions are tested at the latter time to determine the delta of the combined transactions.

Example: Foreign person (“FP”) buys a call option on XYZ stock with a term of six months. The initial delta of the call is 45. Three months later, FP re-evaluates the position and writes a three-month put on XYZ stock. At the time FP writes the put, the delta of the call

⁸ Note, however, that if the option’s delta dropped below 70, the taxpayer could close out the position and re-establish it. The re-established position would not be a specified ELI.

⁹ See Prop. Treas. Reg. § 1.871-15(l)(6).

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is 65 and delta of the short put is 25. The combined delta is 90 (65+25), and the combined transaction is therefore a specified ELI.

- The rule on combining transactions applies only to long positions (*i.e.*, positions that give the taxpayer long exposure to the underlying stock). Transactions in which the taxpayer is the short party (*e.g.*, a written call or purchased put option) are not combined with transactions in which the taxpayer is the long party, even if the transactions are entered into in connection with each other. In contrast, if a single NPC or ELI contains multiple references to the same underlying stock, then all such references are taken into account in determining the delta of the NPC or ELI.¹⁰
- If an NPC or ELI has a constant delta, *i.e.*, a delta that is not reasonably expected to vary over the term of the instrument, then it is treated as having a delta of one. If necessary, the number of underlying shares is adjusted to make this rule work.

Example: FP enters into a swap that pays 50% of the appreciation in 100 shares of stock and requires the taxpayer to pay 50% of the decline in value of 100 shares of the same stock. The swap has a constant delta. The swap is therefore treated as having a delta of one with respect to 50 shares of stock.

The 2013 Proposed Regulations also expand the concept of “dividend equivalent.” Like the 2012 Proposed Regulations, the 2013 Proposed Regulations treat an adjustment to the strike price of an option to reflect a special dividend as a dividend equivalent. And like the 2012 Proposed Regulations, the 2013 Proposed Regulations treat a declared or announced dividend as a dividend equivalent if any term of the contract, such as the premium paid for an option, reflects

¹⁰ See Prop. Treas. Reg. § 1.871-15(g)(1) (“If an NPC or ELI contains more than one reference to a single underlying security, all references to that security are taken into account in determining the delta with respect to that underlying security.”)

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the amount of the dividend. Unlike the 2012 Proposed Regulations, however, an estimate of a future dividend that has not been announced or declared is also a dividend equivalent if any term of the contract reflects the amount of the estimated dividend.

Example: FP buys a 70-delta, 90-day call option on a stock that is expected to pay a quarterly dividend during the life of the call. Even though the dividend has not been announced or declared, the amount of the premium paid for the call is presumed to reflect the expected dividend. As a result, the call will be treated as having a dividend equivalent payment if the call remains open over the dividend date.

The preamble to the 2013 Proposed Regulations contains the following explanation of this change:

The 2012 proposed regulations provided that estimates of expected dividends were not dividend equivalents unless the estimate was adjusted to reflect actual dividend payments. The 2013 proposed regulations eliminate this exception and explicitly treat estimated dividend payments as dividend equivalents because the economic benefit of a dividend is present in contracts that use estimated dividends in the same way as a contract that adjusts for actual dividends. Moreover, the Treasury Department and the IRS are concerned that taxpayers may inappropriately avoid section 871(m) if estimated dividends are not treated as dividend equivalents.¹¹

Under the 2013 Proposed Regulations, the fact that the pricing of an equity derivative takes expected dividends into account is sufficient to result in a dividend equivalent, even if the

¹¹ Preamble at p. 23.

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long party is not entitled to receive any payment reflecting the dividend. For example, a price-return-only equity swap, in which the long party receives the appreciation of the referenced stock but not any payment reflecting the dividend, results in a dividend equivalent payment because the pricing of the swap is presumed to reflect the fact that the long party does not get any payment tied to the dividend.¹² Similarly, even though the holder of a call option does not receive any payment relating to a regular dividend paid on the underlying stock and the terms of the option are not adjusted to reflect the dividend, the fact that expected dividends are taken into account (at least implicitly) in the amount of premium is sufficient.

The amount of a dividend equivalent payment is generally determined based on the actual dividend paid even if the pricing of the instrument is based on an estimate of the dividend.

Example: FP buys a 70-delta call on a stock that is expected to pay a \$0.25 dividend during the term of the option. This expected dividend implicitly reduces the premium paid for the call and constitutes a dividend equivalent. Assume that the company increases its regular dividend so that the actual dividend paid while the call is outstanding is \$0.30. Under the 2013 Proposed Regulations, the dividend equivalent is determined based on the amount of the actual dividend.¹³

An exception to this rule is provided if the short party provides the long party with a reasonable estimate of the dividend in writing at the inception of the transaction. In this situation, the

¹² *Id.* at p. 24.

¹³ Note that the holder of the call is not affected economically by the difference between the amount of the expected dividend and the amount of the actual dividend. To the extent the holder received any economic benefit associated with the dividend, it was in the amount of premium paid for the call (which is presumed to have taken into account expected dividends).

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dividend equivalent is determined by reference to the lesser of the estimated dividend or the actual dividend.¹⁴

As a general rule, the amount of a dividend equivalent is adjusted to reflect the delta of a specified NPC or specified ELI on the ex-dividend date. For an option (or other derivative with a delta that is not constant), the delta on the ex-dividend date will likely be different than it was on the date the option was entered into.

Example: FP buys an 18-month option on XYZ stock with an initial delta of 70. The premium paid for the call is presumed to take into account expected quarterly dividends of \$1. On the first ex-dividend date, the delta of the call has dropped to 40. Accordingly, the dividend-equivalent associated with that dividend payment is \$0.40 per share. If the delta of the call increases to 80 on the second ex-dividend date, the dividend equivalent would be \$0.80 per share.

A different rule applies in the case of specified NPCs and specified ELIs with terms of one year or less. For these instruments, which will include the vast majority of listed options, the amount of the dividend equivalent is adjusted to reflect the delta of the instrument when the taxpayer disposes of or terminates the position. If an option lapses, the delta is treated as zero; if an option is exercised, the delta is deemed to be 100.

The 2013 Proposed Regulations also include a broad anti-abuse rule that gives the IRS power to treat any payment or deemed payment with respect to “any transaction” as a dividend equivalent “to the extent necessary to prevent the avoidance of this section.”¹⁵

Special rules for indexes. -- If an NPC or ELI references more than one underlying stock, the taxpayer is generally treated as entering into a separate position with respect to each

¹⁴ See Prop. Treas. Reg. § 1.871-15(h)(2)(iii).

¹⁵ See Prop. Treas. Reg. § 1.871-15(n).

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underlying stock that must be tested under the delta 70 standard. Similarly, dividend equivalents must be separately computed with respect to any such separate position based on dividends associated with each respective underlying stock.

However, if an NPC or ELI references a “qualified index,” then the transaction is not subject to section 871(m). The definition of “qualified index” in the 2013 Proposed Regulations is different from the definition in the 2012 Proposed Regulations. Under the 2012 Proposed Regulations, any broad-based index (as defined under the Securities Act of 1934¹⁶) on which listed options or futures are traded would be a qualified index. Under the 2013 Proposed Regulations, an index must meet the following requirements to be a qualified index:

- It must reference 25 or more U.S. stocks.
- It must reference only long positions in such stocks.
- No underlying stock can represent more than 10% of the index.
- The index can be modified or rebalanced only according to predefined objective rules at set dates or intervals.
- The index cannot provide a dividend yield from the referenced stocks that is more than 150% of the yield on the S&P 500 index as reported for the month immediately preceding the date on which the taxpayer acquires the NPC or ELI on the index.
- Options or futures on the index must trade on a national securities exchange or domestic board of trade.

¹⁶ See § 3(a)(55) of the Securities Act of 1934, as amended.

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The 2013 Proposed Regulations include additional rules relating to the exemption for qualified indexes. For example, if a taxpayer acquires an NPC or ELI with respect to a qualified index and in connection with doing so, the taxpayer (or a related party) enters into a short position with respect to any of the stocks referenced in the index, then the qualified index exemption does not apply.

Withholding and Reporting. -- The 2013 Proposed Regulations require certain parties to a potential section 871(m) transaction to determine whether the transaction is a section 871(m) transaction and the amount of any dividend equivalent payments. For example, if a broker or dealer is a party, the broker or dealer must make these determinations. If both parties are brokers or dealers, or neither party is a broker or a dealer, then the short party is required to make the determinations. These determinations are binding on the parties, unless the other party knows or has reason to know the determinations are incorrect. Certain persons are permitted to request information from a party that is required to make these determinations when they need this information to comply with their withholding or reporting obligations or to determine their tax liability. If a withholding agent reasonably relies on information so provided, it will not be liable for underwithholding. Instead, the party who provided the incorrect information will be liable for the underwithheld tax.¹⁷

The 2013 Proposed Regulations also include rules relating to withholding when there is no actual payment associated with a dividend equivalent. Essentially, these rules require withholding tax to be remitted whenever the party responsible for withholding has custody or control of money or other property of the taxpayer (*e.g.*, funds in a brokerage or margin account). Under the 2013 Proposed Regulations, a clearing organization such as OCC is a withholding agent with respect to dividend equivalent payments made (or deemed made) to its non-U.S. clearing members.

¹⁷ See Prop. Treas. Reg. § 1.1441-3(h)(2).

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III. Discussion

The 2013 Proposed Regulations would apply to many options transactions that are not economic substitutes for owning the underlying stock. Because the tax consequences of entering options covered by the 2013 Proposed Regulations can be harsh and disproportionate to any gain or loss on the option, foreign persons will refrain from entering into the transactions even though they have nothing to do with avoiding dividend withholding tax. As a result, the 2013 Proposed Regulations would unnecessarily disrupt trading on U.S. options exchanges, with a consequent loss of trading volume, a result that Congress clearly did not intend. Apart from the overly broad approach to options, the 2013 Proposed Regulations will require brokers to develop systems to identify options and combined option positions with deltas of 70 and higher, to recompute the deltas of such options on ex-dividend dates and termination dates, and to distinguish among identical options contracts based on whether the option contract had an initial delta of 70 or higher when entered into. The Coalition is concerned that many brokers will not be willing to incur the costs of developing and maintaining these systems and will preclude or restrict options trading by their non-U.S. customers. Many brokers in non-U.S. markets will almost certainly decide not to incur these costs; some of these brokers may allow non-U.S. persons to trade options on U.S. equities and disregard any U.S. withholding tax requirements, resulting in a transfer of options trading from the U.S. to other countries.

The Coalition acknowledges that options can be used to create delta one or near delta one exposure to a stock and that such options should be governed by rules that are similar to the rules for equity swaps. Such equivalent treatment follows from the policy decision, as explained in the preamble, to apply section 871(m) to derivatives that approximate the economics of owning the underlying security. The Coalition strongly disagrees, however, with the proposition that an option with an initial delta of 70 is an economic substitute for owning the underlying stock. Unlike typical equity swaps, forward contracts and futures contracts, which have constant deltas of 100, an option's initial delta applies only for a very small change in the price of the underlying

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stock. The 2013 Proposed Regulations define delta as the ratio of a change in price of a derivative to a change in price of the underlying security. For typical equity swaps, forwards, futures and other derivatives with constant deltas, this definition is workable. However, because the theoretical delta of an option is the slope of the tangent line at an instantaneous point on the price curve of the option,¹⁸ any change in the price of the underlying stock will typically result in a different delta for the option. To convert an option's theoretical delta into more practical terms, options traders sometimes use the expression "up delta" and "down delta" to describe how the price of an option will change if the stock moves up or down by \$1.00. For example, an option with a theoretical delta of 50 might increase in value by \$0.625 if the underlying stock increases by \$1.00 (an up delta of 62.5) and may decrease in value by \$0.375 if the stock price drops by \$1.00 (a "down delta of 37.5").¹⁹

The delta of an option is also different from the delta of an equity swap, forward or future in that it is based on the assumption that other risks that affect the price of an option do not change. Even if the price of the underlying stock does not change, the price of the option will change, and its delta will also change, if there is change in the expected volatility of the underlying stock, a change in short-term interest rates, a change in expected dividends, or the mere passage of time.

The fact that the delta of an option holds only for extremely small changes in the price of the underlying stock and that changes in other variables will cause the option's price to change even if there is no change in the price of the underlying stock make a 70-delta option a poor substitute for owning the underlying stock. A person seeking to approximate the economics of

¹⁸ See, e.g., MacMillan, *Options as a Strategic Investment*, 3d ed. (1993) at p. 90.

¹⁹ See MacMillan, *supra*, at pp. 90-91. ("In the true mathematical sense, there is only one delta and it measures 'instantaneous' price change. The concepts of up delta and down delta are practical, rather than theoretical, concepts which merely illustrate the fact that the true delta changes whenever the stock price changes, even by as little as 1 point.")

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owning a stock -- or to approximate 70% of the change in value of the stock -- would not purchase a 70- delta call and just hold it for any significant amount of time. The risk that the price changes in the option over time will deviate -- and deviate materially -- from price changes in the stock is simply too great. To illustrate the differences in price returns, we looked at calls on the most actively traded equity options in the month of January with deltas in the low 70's and compared the price performance of these options with the price performance of the underlying stock over the same period. The results, based on Bloomberg data, are shown in the table below and on Exhibit 1 to this letter.

P&L Table of Options with 70 to 74 Delta in the Top 10 Most Active Classes ¹							
(Holding Period: Jan 2, 2014 to Jan 31, 2014)							
Symbol	Change in Value			Option Change as a % of Stock Change	Initial	Delta	
	Stock	Option	Difference			Lowest	Highest
AAPL	(\$5,253.00)	(\$4,155.00)	(\$1,098.00)	79.10%	0.736	0.359	0.767
FB	\$786.00	\$605.00	\$181.00	76.97%	0.716	0.683	0.945
MSFT	\$68.00	\$16.00	\$52.00	23.53%	0.723	0.504	0.827
TWTR	(\$300.00)	(\$350.00)	\$50.00	116.67%	0.725	0.602	0.771
TSLA	\$3,131.00	\$2,845.00	\$286.00	90.87%	0.727	0.640	0.942
GM	(\$487.00)	(\$313.00)	(\$174.00)	64.27%	0.715	0.315	0.728
NFLX	\$4,651.00	\$3,060.00	\$1,591.00	65.79%	0.717	0.519	0.939
GOOG	\$6,785.00	\$5,300.00	\$1,485.00	78.11%	0.721	0.699	0.906
JPM	(\$285.00)	(\$244.00)	(\$41.00)	85.61%	0.738	0.535	0.828
FCX	(\$522.00)	(\$280.00)	(\$242.00)	53.64%	0.723	0.240	0.723

¹Most active by ADV in January 2014

A fixed delta instrument with an actual delta of 70 would be expected to have price performance approximating 70% of the price performance of the underlying stock. In other words, if the underlying stock increased in value by \$100, the 70 delta instrument should increase in value by \$70. As illustrated in the table above, the price performance of the options for the stocks in the sample ranged from a low of 23.5% of the change in price of the referenced stock (Microsoft) to a high of 116.7% of the change in price of the referenced stock (Twitter).

The differences in the price returns on low 70-delta options and the underlying stock mean that a foreign person seeking to approximate the economics of owning a stock using

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options -- as distinct from using swaps, forwards and futures -- cannot simply put on an option position like a 70 delta call option. Rather, if the objective is to approximate the economics of owning the stock, or to approximate 70% of those economics, the foreign person would need to continually adjust the options position to maintain a delta of 70 over time. In other words, maintaining a constant delta using options requires rebalancing the option position by adding or reducing the number of options as the delta of the position changes over time. Such a technique could be viewed as a form of dynamic hedging. As explained by John Hull, one of the leading authorities on options:

“It is important to realize that, because delta changes, the investor’s position remains delta hedged (or delta neutral) for only a relatively short period of time. The hedge has to be adjusted periodically. This is known as rebalancing. . . . The delta-hedging scheme just described is an example of a *dynamic hedging* scheme. This scheme requires the hedge position to be adjusted periodically. Dynamic hedging can be contrasted with *static hedging* where the hedge, once set up, is never adjusted. Static hedging schemes [such as hedges involving forward contracts] are sometimes referred to as *hedge-and-forget schemes*.”²⁰

One consequence of the approach to options (and other investments with variable deltas) is that identical options entered into at different times will be specified ELIs if entered into when their initial delta is 70, but will not be if entered into when delta is below 70. As shown in the table above, all of the options in the sample had initial deltas on January 2, 2014, between 70 and 74, and each of these options had deltas below 70 on one or more trading days during the month. Here is the data from Exhibit 1 (Tab 2) for Apple, which had the most actively traded equity options for the month (and for all of 2013):

²⁰ Hull, *Options, Futures and Other Derivatives*, 4th ed. (2000) at pp. 311-312.

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<u>Date</u>	<u>AAPL</u>		<u>Delta</u>
	<u>Price (U)</u>	<u>Price (O)</u>	
1/2/2014	553.13	51.3	0.736
1/3/2014	540.98	43.9	0.669
1/6/2014	543.93	44.05	0.686
1/7/2014	540.038	40.84	0.667
1/8/2014	543.46	42.18	0.683
1/9/2014	536.519	37.17	0.649
1/10/2014	532.94	34.67	0.631
1/13/2014	535.73	39.55	0.68
1/14/2014	546.39	40.45	0.697
1/15/2014	557.36	51.25	0.766
1/16/2014	554.25	47.15	0.767
1/17/2014	540.67	40.7	0.689
1/21/2014	549.07	44	0.721
1/22/2014	551.51	45.24	0.751
1/23/2014	556.18	46.35	0.755
1/24/2014	546.07	41.8	0.702
1/27/2014	550.5	46	0.752
1/28/2014	506.5	12.9	0.416
1/29/2014	500.75	10.25	0.368
1/30/2014	499.782	10.4	0.362
1/31/2014	500.6	9.75	0.359

As indicated above, the option had an initial delta of 0.736 on January 2 and had a delta of less than 70 on 13 trading dates during the month of January.²¹ As a result, if a foreign person entered into this option on various dates during the month, some of the contracts would be specified ELIs, while other identical contracts would not. In addition, a foreign person who entered into the contract on January 2 could have closed it out on any day when the option had a delta below 70 and re-established the identical option. A foreign person (Foreign Person A)

²¹ These values are based on daily closing prices. The option likely had a delta lower than 70 on other days based on intra-day trading prices.

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following this strategy would not have a specified ELI, while a foreign person (Foreign Person B) who simply continued to hold the original option would have a specified ELI. Foreign Person A would not have a dividend equivalent on February 11, the ex-dividend date for the dividend that Apple declared on January 27, while Foreign Person B would have a dividend equivalent on that date, even though they hold identical options.

In evaluating how much variation between the price return on an option and the price return on the stock a foreign person might be willing to accept in order to avoid withholding tax, it is important to keep in mind that the withholding tax on a regular dividend is typically a very small percentage of the price of the stock. The average annual dividend yield for the stocks in the S&P 500 that pay regular dividends is currently about 2.4 %. For a stock trading at \$100, this yield translates into a quarterly dividend of \$0.60 per share. The associated withholding tax would be \$0.18 per share (\$0.09 per share if a tax treaty applies). The withholding tax thus represents at most 0.18% (0.0018) of the stock price. In evaluating whether a delta 70 option has a potential for tax avoidance, we think it is critical to evaluate whether a rational non-U.S. person would enter into the transaction in order to gain economics approximating those of owning the stock while avoiding the dividend withholding tax that would apply if he or she owned the stock. Entering into such an alternative transaction would make sense only if the transaction affords a better risk-adjusted, after-tax return. The minute size of the withholding tax relative to stock price means that a rational foreign person would use options as a substitute for owning the stock only if it is reasonably certain that the price change in the option will deviate from the price change of the stock by an amount even smaller than the amount of the avoided withholding tax.

In evaluating whether a rational non-U.S. person would enter a 70-delta option (or other alternative transaction) to get the economics of owning the stock and avoid dividend withholding tax, it is also important to keep in mind that a non-U.S. person holding the stock can sell it at the close of the day before an ex-dividend date and buy it back at the open on the ex-dividend date. By following this strategy, the non-U.S. person receives the economic benefit of the dividend --

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in the form of additional sales proceeds attributable to the pending dividend -- and has all of the economics of owning the stock except for overnight price risk. Any rational non-U.S. person would view any alternative transaction, such as a delta 70 option, in comparison to this baseline transaction to determine if it affords a better risk-adjusted, after-tax return.

In sum, using a delta threshold of 70 to identify options subject to section 871(m) is inconsistent with the stated policy decision that section 871(m) should apply to derivatives that approximate the economics of owning the stock. As discussed above, a taxpayer holding a 70-delta call will not predictably have a return that approximates the return on the stock, or even 70% of the return on the stock, unless the taxpayer continuously adjusts the position using dynamic hedging concepts. A taxpayer that rebalances a position using dynamic hedging concepts can properly be viewed as maintaining a position with a constant delta, and the rules in the 2013 Proposed Regulations relating to transactions with fixed deltas can properly apply. In the absence of such rebalancing, however, a delta of 70 is simply too low and the price return on the option is likely to vary too significantly from that of the stock to make such an option an attractive means of approximating the economics of owning the underlying stock and avoiding dividend withholding tax. While it is obviously necessary to cover transactions that deviate from ownership in immaterial respects, it is clearly inappropriate to extend section 871(m) to transactions that entail materially different risks and rewards from those associated with stock ownership. If the overly expansive approach in the 2013 Proposed Regulations had no costs, this over-breadth might be acceptable. However, the over-breadth will likely have significant, adverse effects as non-U.S. persons will refrain from engaging in options transactions that do not have the potential for tax avoidance, resulting in a loss of both trading volume and beneficial economic activity.

We would also like to note that, unlike the delta of typical swaps, forwards and futures, the delta of an option is not “objective.” Rather, it requires predicting interest rates, dividends, and most significantly the future volatility of the underlying stock over the option’s term. While

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near-term interest rates and near-term dividends can generally be predicted with a fair degree of accuracy, future volatility of the underlying security is unknowable²² and market participants can reasonably have different views of what that future volatility is going to be. Reasonable estimates of volatility can be based on (i) recent historic volatility, (ii) the volatility implied by an option's current price,²³ or (iii) an analysis of macroeconomic, industry-specific, or company-specific events that may occur during the option's term. The fact that the determination of delta requires an estimate of future volatility has significant implications. First, market participants entering into identical options at the same time may receive different tax treatment based on their estimate of future volatility or on their particular broker's estimate of future volatility as long as such estimate is reasonable. Second, the fact that reasonable estimates of future volatility may vary significantly will make it challenging for the Internal Revenue Service to audit the reasonableness of a taxpayer's determination of an option's delta.

Finally, we wish to note that options with a delta of 70 are not always deep in the money.

Example: A 90-day, \$50 call on a \$53 stock that is expected to pay a \$0.25 dividend and that has expected volatility of 25% has an initial delta of .7042.

Example: A 30-day, \$20 call on a \$21 stock that is expected to pay a \$0.10 dividend and has an expected volatility of 30% has an initial delta of .7368.

²² See, e.g., Options Institute [ed], *Options: Essential Concepts and Trading Strategies* (2d edition 1995) at p. 37 (“[O]ne can conclude that an option's theoretical value is ultimately subjective. After all, it is the future volatility of a stock that determines an option's true value and the future volatility, of course, cannot be known.”)

²³ Options on the same underlying stock but with different strike prices often have different implied volatilities. This phenomenon is referred to as “skew”.

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Example: A 90-day, \$52.50 put on a \$50 stock that is expected to pay a \$0.50 dividend and has an expected volatility of 20% has an initial delta of .7056.²⁴

Combining Deltas When a Transaction is Entered Into in Connection with Another Transaction. -- The 2013 Proposed Regulations provide that if potential section 871(m) transactions referencing the same underlying stock are entered into in connection with each other (whether simultaneously or sequentially), then the transactions are combined and treated as a single transaction for purposes of determining delta. It is not clear what follows from treating the transactions as a single transaction for this purpose. The three examples in the 2013 Proposed Regulations illustrating the application of this rule all involve a purchased call and a written put that are entered into in connection with each other.²⁵ The examples state that because the “in connection with” test is met, the delta of the purchased call and written put are combined to determine if the initial delta is 70 or higher. For example, in Example 1, the delta of a long call on 100 shares of stock X is 45 and the delta of a written put on 100 shares of stock X is 40 when the options are entered into. The combined deltas total 85 and thus the 70 delta threshold is met.

We agree with this approach as it applies to combinations of long calls and written puts. The long call gives the taxpayer upside exposure and the written put gives the taxpayer downside exposure. The two options complement each other by increasing the similarity of the taxpayer’s economic exposure to that of owning the underlying stock.

However, the same approach should not apply if the options transactions expose the

²⁴ The deltas in these examples were computed using CBOE’s online options calculator located at http://www.cboe.com/framed/IVolframed.aspx?content=http%3a%2f%2fcboe.ivolatility.com%2fcalc%2findex.j%3fcontract%3d3715D472-847E-4F2A-A191-1F3F6AE0B264§ionName=SEC_TRADING_TOOLS&title=CBOE%20-%20IVolatility%20Services.

²⁵ See Prop. Treas. Reg. § 1.871-15(l)(6).

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taxpayer to the same or similar risks and rewards. For example, if a taxpayer buys two call options each on 100 shares of stock X and each of which has an initial delta of 50, the deltas should not be combined to yield a 100 delta position on 100 shares of stock. Rather than complementing the exposure created by the first long call by writing a put, the taxpayer has simply replicated the same exposure with respect to a second block of 100 shares of stock. Moreover, combining the deltas of the two long calls in the same manner as the deltas of a long call and a written put would lead to the absurd conclusion that a single call option on 100 shares of stock with a 50 delta should be viewed as a 100 delta call on 50 shares of stock, and a similar call option with a delta of 10 should be viewed as a 100 delta call on 10 shares of stock. This is the approach that the 2013 Proposed Regulations take to instruments with constant deltas, but it does not make sense to apply it to options (unless, as noted above, the taxpayer uses dynamic hedging techniques to maintain a constant delta).

There is one context in which it may make sense to combine deltas in this way. That would be where the circumstances indicate that the taxpayer intends for the option to create a delta hedge on a number of shares of underlying stock that differs from the number of shares specified in the contracts. For example, if a foreign person sells 1,000 shares of a U.S. stock the day before an ex-dividend date, purchases 50-delta call options on 2,000 shares of the stock, and then reverses these transactions the next day (*i.e.*, buys back 1,000 shares and closes out the calls), it may be that the taxpayer was trying to maintain overnight exposure to 1,000 shares of stock and avoid the withholding tax on the dividends. Such a strategy exposes the taxpayer to substantial volatility risk and it is not clear that a rational person would pursue this strategy, given the risks and transaction costs. However, if Treasury and IRS have concerns regarding the use of such a strategy, a special rule to address it could be adopted.

Spreads and Other Strategies Involving Multiple Options Positions. -- There are many standard options strategies that involve multiple options positions. These transactions often combine options having positive deltas with options having negative deltas. A common example

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is a bull call spread, which consists of buying a call at one strike price and selling a call on the same stock and with the same expiration date at a higher strike price.²⁶ Because the call with the lower strike price is more expensive, the trader using this strategy incurs a net debit (*i.e.*, makes a net payment) to enter into the transaction. The maximum profit from the transaction is realized if the stock price is above the strike price of the written call, in which case the trader's gain is the difference between the two strike prices minus the net debit to enter the transaction. The maximum potential loss is the net debit amount.

Example: FP enters into a bull call spread -- long call with \$25 strike price, short call with a \$30 strike price -- for a net debit of \$2. The maximum profit from the spread is \$3 -- the \$5 difference between the strike prices of the two calls minus the \$2 net premium paid for the spread. The maximum loss is \$2.

Spreads and other similar transactions involving multiple options positions can be entered into as a single transaction on an options exchange, and this is typically how the transactions are entered into. The bid and ask prices are the all-in or net price for the spread (*e.g.*, \$2 in the example above), rather than separate bid and ask prices for the component options. These transactions represent a significant portion of volume on U.S. options exchanges. As noted above, over 25% of all contracts entered into on the CBOE in 2013 were spreads and other complex trades entered into pursuant to a single order.

Under the 2013 Proposed Regulations, only positions with positive deltas are taken into account in determining whether a transaction involving multiple option positions meets the delta 70 test. By looking only at the options positions in a spread that have positive deltas, the 2013 Proposed Regulations will cause spreads (and similar strategies) to be section 871(m) transactions even though they have net deltas below 70.

²⁶ Other strategies include bear call spreads, bull and bear put spreads, calendar spreads, back spreads, butterflies, condors, straddles and strangles.

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Example: FP enters into a bull call spread that consists of a long call with a strike price of \$80 and a short call with a strike price of \$90, both with 70-day terms. Assume the stock is trading for \$85, expected volatility is 25% and the expected dividend is \$0.50. The delta for the long call is .7239 and the delta of the short call is -.3022, for a net delta of .4217. Under the 2013 Proposed Regulations, the long call would be a specified ELI and the short call would not be taken into account.

This approach to spreads and other complex strategies fails to reflect the economics of the transaction, which is starkly different from the economics of owning the underlying stock. Protecting the withholding tax on U.S.-source dividends, which is the policy objective underlying section 871(m), in no way requires applying section 871(m) to these strategies. Spreads and other complex strategies are characterized by a high degree of optionality and should be tested based on their economics, *i.e.*, their net deltas.

The 2013 Proposed Regulations would apparently take a different approach to spreads and similar transactions in the OTC market. A spread in the OTC market can be documented as a single contract, which will be viewed as a single instrument for tax purposes. Under the 2013 Proposed Regulations, if a single instrument contains multiple references to the same underlying stock, “all references to that underlying security are taken into account in determining the delta with respect to that underlying security.”²⁷ Thus, if the spread in the above example were executed as a single contract in the OTC market, the transaction would have a delta of .4217 and section 871(m) would not apply. This disparate treatment would cause trading volume to move from regulated exchanges with central counterparty clearing to the OTC markets, which would be contrary to the objectives of Dodd Frank and other regulatory reforms.

When entered into pursuant to a single transaction, the same approach of looking at the

²⁷ See Prop. Treas. Reg. § 1.871-15(g)(1).

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net delta should apply to both listed options and OTC options. Apart from the competitive impacts that different approaches would create, in both cases there is a single counterparty and if the counterparty is hedging, it will hedge on a net delta basis. In addition, when a taxpayer modifies an existing spread (or other complex positions involving multiple options), the combined positions should continue to be tested based on their net deltas.

Expected Dividends. -- The 2013 Proposed Regulations would expand the concept of dividend equivalent to include the amount of an expected but unannounced/undeclared dividend if it is reflected, explicitly or implicitly, in the premium paid for an option. The Coalition believes that this expansion is unwarranted and likely exceeds the scope of Treasury's authority to expand the statutory reach of section 871(m) to cover "payments" that are "substantially similar" to substitute dividends paid in respect of securities loans and repos or to dividend equivalent payments on NPCs.

In the listed options market, the price at which an option transaction occurs -- the premium paid for the option -- is determined by supply and demand. The fact that the theoretical fair value of an option under various pricing formulas takes into account expected dividends is not determinative of the price at which any given option trade occurs on an exchange. Thus, the amount of any expected dividends is not used in computing the premium paid, even implicitly.²⁸

The preamble to the 2013 Proposed Regulations explains that the proposed treatment of expected but undeclared dividends is based on two considerations. One is that the economic benefit of a dividend is present in contracts that use estimated dividends in much the same way as contracts that adjust for actual dividends. The other is that failing to include expected dividends would permit avoidance of withholding tax. As for the first point, we would note the

²⁸ Although the strike prices of listed options are typically adjusted to reflect special dividends, the terms of an option are not adjusted to reflect the payment of a regular dividend even if the amount of such dividend differs from market expectations.

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long party to a contract with terms based on expected dividends bears dividend risk. The amount of a near-term dividend can generally be predicted with some accuracy, though companies often announce increases or decreases in the amount of a regular dividend only shortly before an upcoming dividend date. Predicting the amount of expected dividends further out in time is less precise.

Even in the case of near-term dividends, there is an additional consideration that weighs against treating an option entered into before a dividend announcement date as having dividend equivalents based on expected dividends. Dividends are typically announced at the same time that a company reports its quarterly earnings. The period leading up to an earnings report, which generally occurs a couple of weeks before the dividend date, is often a period of increasing volatility in the stock and in the volatility implied by prices of options on the stock. These changes in volatility have a direct impact on the deltas of options on the stock, making these deltas particularly unstable. The market uncertainties associated with an upcoming earnings announcement make a delta-70 option entered into prior to the date of the earnings report, which coincides with the announcement of the dividend, even less of an economic substitute for owning the stock. Options (at least other than options with deltas approaching 100) are unlikely to pose a risk of tax avoidance of an unannounced expected dividend because the delta of the options is likely to change significantly as volatility increases in the period leading up to earnings announcement.

As for concern about the potential for avoidance, we would make two observations. As noted above, a non-U.S. person can obtain almost all of the economics of owning stock and the benefit of a dividend free of withholding tax by selling the stock at the close the day before the ex-dividend date and buying it back the next morning. Under the 2013 Proposed Regulations, the non-U.S. person can also enter into a delta 69 call option overnight, thereby substantially reducing exposure to overnight price risk. Treasury's authority under section 871(m) does not extend to treating the portion of the sales proceeds attributable to a pending dividend as a

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dividend equivalent. Thus, this means of avoiding dividend withholding tax will continue to exist.

As compared to this baseline transaction for avoiding withholding tax, entering into an option before a dividend announcement (and associated earnings report) is a very poor choice as a means of obtaining the economics of stock ownership and avoiding withholding tax. Moreover, as with the baseline transaction, Treasury appears to lack the authority to treat an expected dividend as a “payment” that is “substantially similar” to substitute dividends paid with respect to securities loans and repos or dividend equivalents on NPCs. There is no “payment” to the options holder in respect of the expected dividend and there is no adjustment to the term of the option to reflect the expected dividend (or the actual payment of the dividend). For purposes of section 871(m), the term payment is expanded beyond its normal meaning to include “any gross amount which is used in computing any net amount which is transferred to or from the taxpayer.”²⁹ This language picks up the gross amount of a dividend to which the long party of a total return equity swap is entitled even though that gross amount is netted with other amounts to determine the net payment the long party is entitled to receive (or obligated to make) under the swap. However, this language has no application in the context of the determination of the amount of premium paid for a listed option. As noted above, a listed option’s price is determined by supply and demand and is the result of matching bid and offer prices posted in the marketplace. The premium is in no sense a “net amount” paid by the option buyer to the option seller. The premium is not “net” of any amount; it is simply a gross payment.

If Treasury nonetheless decides to retain this expansive concept of a dividend equivalent payment, the Coalition requests that the proposed rule regarding upfront written estimates of expected dividends be modified so that it can apply to listed options. In its current proposed form, this rule provides that if the short party provides a reasonable upfront written estimate of a

²⁹ See Code § 871(m)(5).

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dividend to the long party, then the amount of the dividend equivalent will be equal to the lesser of the estimated amount or the actual amount of the dividend. This rule contemplates the bilateral relationship that exists in the OTC market but does not exist in the listed market. We recommend that the rule be modified to provide that brokers may provide written estimates of expected dividends to their customers and that the options exchanges can post information on expected dividends that will qualify under the rule.

Options with Terms of One Year or Less. -- The vast majority of listed options transactions have terms of less than a year.³⁰ Under the 2013 Proposed Regulations, the amount of a dividend equivalent with respect to an option with a term of one year or less is determined by multiplying the amount of the actual dividend by the delta of the option when it is closed out or expires. The delta of an option that expires is treated as zero. The delta of an option that is exercised is treated as 100.

While this rule has some benefits, it can have undesirable consequences when the strike price of an option on its expiration date is close to the stock price. If not closed out or exercised earlier,³¹ listed options expire at the close of trading on their expiration date, which is typically the third Friday of the month. For an option that is close to being at the money on its expiration date, very small changes in the price of the underlying stock can cause the option to move from being in the money to out of the money and *vice versa*, and can cause the delta of the option to swing wildly. Small changes in the price of the underlying stock when an option is about to expire can thus have an outsized impact on the amount of a dividend equivalent deemed to have been received.

³⁰ In fact, most options have much shorter terms. For 2013, approximately 76% of all listed options contracts on the CBOE had terms of two months or less and 83% had terms of three months or less. These statistics are based on the stated term of the options and do not include options with longer stated terms that are closed prior to expiration.

³¹ Options are only rarely exercised prior to their expiration date.

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Example: At a time when XYZ stock is trading for \$53, FP pays \$4.21 for a 90-day call option with a strike price of \$50. The expected volatility of XYZ stock is 25% (annualized) and XYZ is not expected to pay a dividend during the 90-day period. The option has an initial delta of .7042. Three weeks later, XYZ announces a special dividend of \$5 a share. Once the stock goes ex-dividend, the price of XYZ stock drops by \$5 and the strike price of the option is reduced by \$5 to \$45. Assume the option remains outstanding on day 90 and that at 2 o'clock in the afternoon, XYZ stock is trading at \$45.15. Given the short time (2 hours) until the option expires, the option will be trading for \$0.15 and will have a delta approaching 100. If FP closes out the option for \$0.15, he will be deemed to have received a dividend equivalent payment equal to (or perhaps slightly less than) \$5 even though he lost \$4.06 on the option. In contrast, if FP leaves the option in place and XYZ stock closes at \$44.99 or lower, the option will expire worthless and FP's dividend equivalent will be zero. Alternatively, if XYZ stock closes at \$45.01 or higher, the option will be automatically exercised (unless OCC has received contrary instructions). In this scenario, FP would be deemed to have received a dividend equivalent equal to the full amount of the \$5 dividend.

The scenarios portrayed in this example illustrate the uneconomic consequences that may result from the "one year or less" rule when an option is very close to expiration and slightly in or out of the money. We believe that these results can be avoided and a much simpler approach can be adopted for determining the amount of a dividend equivalent if the delta threshold for options is increased from 70 to 90 or 95. If the general rule is modified to treat options as specified ELIs only if they have initial deltas of at least 90 or 95, then the amount of the dividend equivalent can simply be equal to the amount of the actual dividend. Such a rule would eliminate the requirement that deltas be remeasured either on the ex-dividend date (for options with terms of more than one year) or on the date the option is terminated or expires (for options with shorter terms). Raising the delta threshold to 90 or 95 makes this simplification reasonable.

Separately, we wish to point out that the rule treating delta as zero if an option lapses

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does not seem to make sense in the case of a written put options subject to section 871(m). The writer of a put option realizes his or her maximum profit when the put lapses. If there is a special dividend, the corresponding reduction in the strike price of the put protects the put writer. If the “one-year-or-less” rule is retained, its application to written put options may warrant further consideration.

Index Options. -- Under the 2012 Proposed Regulations, an index would be a “qualified index” if it is broad-based for purposes of the securities laws and options or futures contracts on the index are traded on U.S. exchanges. For reasons that are unclear, the 2013 Proposed Regulations abandon this approach and include an *ad hoc* list of requirements that an index must meet in order to be a qualified index. While we understand that these requirements were developed so that standardized broad-based indexes (such as the S&P 500 or the NASDAQ 100) would be qualified indexes and “customized indexes” would not be, the requirements would appear to result in most established indexes being nonqualified. For example, one of the requirements in the 2013 Proposed Regulations is that no single stock represent more than 10% of the index. This rule will disqualify the NASDAQ 100 because Apple stock represents more than 10% of the index. This rule could also disqualify the Dow Industrials: While no stock currently represents 10% of the index, Visa stock currently represents approximately 9% of the index and several months ago IBM was approximately 9.5% of the index. Another requirement is that the index is modified or rebalanced only according to predefined objective rules at set dates or intervals. Our understanding is that the S&P 500 (as well as other standard, broad-based indexes) would not meet this requirement because (i) the manager of the index makes subjective judgments as to which specific stocks should be added or deleted, and (ii) stocks are not replaced solely at set dates or intervals, *e.g.*, a stock may have to be replaced when the issuer is acquired in a merger or goes bankrupt. Another requirement is that the dividend yield on the index must not exceed 150% of the dividend yield on the S&P 500 for the month preceding the day the transaction is entered into. This requirement may be problematic because of the seasonal nature of dividends (*e.g.*, January is a low month for dividends).

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The Coalition strongly urges Treasury to drop these *ad hoc* requirements and instead define qualified indexes to include any broad-based index as defined under the securities laws on which listed options or futures are traded. This definition also applies to determine whether an index option or future is subject to the rules of Code section 1256. It is a standard that market participants are familiar with. Moreover, a broad-based index by definition does not create exposure to an individual stock and thus a derivative on an index is not a means by which a foreign person can gain the economic equivalent to owning a particular stock. Revenue Ruling 2008-31, 2008-26 I.R.B. 1180, addresses the analogous issue in the FIRPTA context. That ruling held that a swap on a broad-based U.S. real estate index is not a U.S. real property interest subject to tax under Code section 897. The Coalition believes that a similar approach is appropriate here in light of the purposes of section 871(m).

Defining “qualified index” so that it includes all broad-based indexes traded on option and futures exchanges is critical in light of the fact that the rules in the 2013 Proposed Regulations governing section 871(m) transactions with respect to non-qualifying indexes are impractical. Under the 2013 Proposed Regulations, if an index is not a qualified index, then a taxpayer is treated as entering into a separate position with respect to each stock in the index that must be tested under the delta 70 standard. Thus, a taxpayer’s position with respect to the index may include positions with respect to some component stocks that are section 871(m) transactions while positions with respect to other component stocks are not. As dividends are paid on the component stocks, deltas of the positions that are subject to section 871(m) would need to be retested to measure the amount of dividend equivalents. If the interest in the index has a term of less than a year, then it would apparently be necessary to determine the deltas of all the positions in component stocks that are deemed to be section 871(m) transactions at the time the NPC or ELI is closed out or expires. It is not apparent how all of this could actually be done in practice. In effect, this approach will bar non-U.S. persons from entering into swaps, forwards, futures or delta-70 options on any index that is not a qualified index.

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One consideration that bears on the policy decision to exempt qualified indexes is that there are exchange-traded funds (“ETFs”) that are designed to track the performance of such indexes. If an NPC or ELI on a qualified index is exempt but an NPC or ELI on an ETF tracking the index is subject to section 871(m), consistency concerns are presented. However, we do not believe these concerns are of sufficient force in this context to subject broad-based indexes to the unworkable rules that apply to non-qualified indexes. Rather, if consistency considerations lead Treasury and IRS to decide that NPCs and ELIs with respect to broad-based indexes and NPCs and ELIs with respect to ETFs that track such indexes should be taxed similarly under section 871(m), then the Coalition urges Treasury and the IRS to treat such ETFs as qualified indexes. This decision can be justified by the fact that such an ETF affords a foreign person with exposure to a broad-based index of stocks in much the same way as the qualified index does.³²

Burden on Brokers and Others. -- The New Proposed Regulations would require brokers to develop systems to identify options with initial deltas of 70 or higher and to determine the delta of an option on the ex-dividend date or on the termination date (for options with terms of one year or less). Brokers would have no need to make these determinations except for purposes of meeting their obligations under the section 871(m) regulations.

In order to properly compute the delta of an option, a broker’s system will need to capture the price of the underlying stock at the time the option is entered into. For example, if a foreign person purchases a call at 2:45 p.m., the broker’s system will have to capture the stock price at 2:45 p.m. and compute an initial delta on that basis. Given delta’s sensitivity to the price

³² We note that inconsistencies between derivatives over broad-based indexes and derivatives over ETFs that track such indexes already exist. For example, a listed option or future on a broad-based index is a section 1256 contract, marked to market annually with gain or loss treated as 60% long-term capital gain or loss and 40% short-term capital gain or loss. In contrast, a taxpayer with an option or future on the ETF is taxed under the realization method and will generally have long-term or short-term capital gain depending on holding period. In addition, to the extent index ETFs distribute dividends, they are typically capital gain dividends that are not subject to U.S. withholding tax, and ETFs tend not to distribute much in the way of ordinary dividends.

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of the underlying stock, any other approach -- such as using the opening price or closing price of the stock -- would be too inaccurate. The broker's system will also need to contain an estimated volatility for the stock over the term of the option, and different brokers may adopt different approaches to estimating future volatility. A customer may enter multiple identical options transactions over the course of a day or on different days, and some may have deltas greater than 70 while others do not. A broker's system will thus need to be able to distinguish among fungible options.

Example: At 10:30 a.m., FP buys a 90-day, \$50 call on XYZ stock, which at the time is trading at \$53. The stock is expected to pay a \$0.25 dividend and has an expected volatility of 25%. The call has a delta of .7042 and would be a specified ELI. At 2 p.m. on the same day, XYZ is trading for \$52.50 and FP buys another 90-day, \$50 call, identical to the call he purchased at 10:30. This call has a delta of .6755 and is not a specified ELI.

It seems likely that many brokers will not be willing to incur the expense to develop and maintain systems capable of meeting these requirements. They may simply tell their foreign customers that they cannot enter into long options positions. Alternatively, they may significantly restrict their foreign customers' ability to enter into listed options transactions.

Foreign persons may also be reluctant to trade options on U.S. stocks even if their broker were to develop such a system. First, brokers will likely pass on the expense of building and maintaining the systems to their foreign customers, which will make trading options on U.S. stocks more expensive. Second, the foreign person will be stuck with the delta calculation generated by the broker's system, which will depend in part on the estimated volatility value used by the system. The foreign person may have a different view as to the expected volatility, but would be bound, absent unusual circumstances, by the broker's determination.

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IV. Recommendations

1. Delta.

- An option should have an initial delta of at least 90 or 95 to be treated as a specified ELI. A non-U.S. person would not enter into a 70-delta option and simply hold it for any period of time if the person's objective is to replicate the economics of owning the underlying stock. The risk factors that determine changes in the option's value -- including changes in volatility and changes in the delta of the option -- will cause the price return on the option to deviate in unpredictable ways from the price return on the underlying stock. Dividend withholding tax as a percentage of stock value is typically very small (0.18% or less for the average dividend-paying stock in the S&P 500) and a rational foreign person would not enter into an alternative transaction to avoid that withholding tax unless the transaction affords a better risk-adjusted, after-tax return. A delta threshold of 90 or 95 would more precisely target transactions with a potential for tax avoidance and would minimize adverse effects on the listed options market.
- If a non-U.S. person uses rebalancing techniques to maintain a constant delta with options, the position could be subject to the same rules that apply to NPCs and ELIs with constant deltas. For example, if a non-U.S. person acquired 30-delta call options on 1,000 shares of stock and modified the options position over time to maintain a constant delta, the person could be treated as having a delta one position on 300 shares.
- The deltas of options entered into in connection with each other should not be combined if the options replicate the same or similar risks with respect to additional shares of stock. If a non-U.S. person buys a call on 100 shares of stock X with a delta of 40 and writes a put on 100 shares of stock X with a delta of 50, and the

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options are entered into in connection with each other, the deltas can appropriately be combined to yield a delta of 90. The long call gives the person upside exposure to the stock and the written put complements that exposure by giving the person downside exposure, resulting in pay-offs that more closely track those of owning the stock. In contrast, if the person buys two 40-delta calls on stock X, each covering 100 shares, the deltas should not be combined. The second call merely replicates the same exposure as the first call with respect to an additional 100 shares of the stock.

- The delta of spreads and other complex strategies should be determined on a net basis. Spreads and similar strategies involving multiple option positions typically involve options with positive deltas and options with negative deltas. These transactions are typically entered into pursuant to a single order and represented over 25% of all contract volume on the CBOE in 2013. These transactions have substantial optionality and are not economic substitutes for owning the underlying stock. Their deltas should be determined on a net basis.

2. Dividend Equivalents.

- Expected dividends should not be treated as dividend equivalents with respect to options. Even though near-term dividends can be estimated with a fair degree of accuracy, dividend risk still exists as companies announce a change in dividend distribution policy shortly before the next scheduled dividend date. In addition, dividends are typically announced at the same time as earnings are reported and volatility tends to spike around that time. Thus, the deltas of options entered before the earnings announcement are particularly unstable for the period leading up to the earnings report and dividend announcement date. Moreover, it is not clear that Treasury has the authority to treat expected dividends as “payments.”

- If the delta threshold for options is increased to 90 or 95, the calculation of

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the dividend equivalent can be greatly simplified by making it equal the actual dividend. The approach in the 2013 Proposed Regulations requires calculation of deltas on the ex-dividend date or on the date an option is terminated. These rules can have untoward consequences, particularly when an option is close to at the money on the expiration date. The complications created by these rules can be avoided if only options with very high deltas (90 or 95 or above) are covered, in which case the actual amount of the dividend can appropriately be used without any delta adjustment.

3. Qualified Indexes.

- Qualified indexes should include any broad-based index (as defined under the securities laws) on which listed options and futures are traded. The *ad hoc* requirements for qualified indexes in the 2013 Proposed Regulations would appear to disqualify most standardized indexes, including the S&P 500 and the NASDAQ 100. The definition of broad-based indexes in the securities laws is intended to prevent the index from being an economic substitute for owning one or a few stocks and it can thus serve a similar purpose under section 871(m). The rules for specified NPCs and specified ELIs on non-qualified indexes are not workable in practice and effectively preclude foreign persons from entering into such positions. ETFs that track qualified indexes should be treated in the same way as qualified indexes.

4. Reducing Complexity and Burden.

- Safe harbors and other simplifying rules. -- The Coalition urges Treasury and IRS to include safe harbors and other rules that will reduce the burden on brokers, withholding agents and other market participants of complying with regulations once they are finalized. For example, an "eyeball test" safe harbor for identifying options that are specified ELIs could be based on the relative intrinsic and extrinsic value of

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the options. The intrinsic value of an option refers to the amount by which it is in the money and the extrinsic value (or time value) refers to the amount by which the total value of the option exceeds its intrinsic value. For example, if a stock is trading at \$50, and a call option on the stock with a strike price of \$47 is valued at \$4.50, the option has \$3 of intrinsic value and \$1.50 of extrinsic (or time) value. As a general matter, options with meaningful extrinsic value have significant optionality and are not economic substitutes for owning the stock. If the delta threshold for treating an option as a specified ELI is increased to 90 or 95, as we recommend, then an appropriate safe harbor might apply to options with an initial intrinsic value that is less than 90% of its total value. In other words, if 10% or more of the option's value is extrinsic value, then the safe harbor would apply. Options satisfying this test are very unlikely to have deltas over 90 as long as the term of the option is one year or less.

Another helpful feature would be some kind of *de minimis* test. For example, Citibank is one of the most actively traded options on U.S. options exchanges. Citibank's stock price is around \$50 a share and Citibank pays a quarterly dividend of \$0.01. Under the 2013 Proposed Regulations, all of the rules for determining whether a Citibank option is a specified ELI and for determining the amount of dividend equivalents would apply to Citibank options even though the withholding tax on Citibank's one cent quarterly dividend is highly unlikely to lead non-U.S. persons who want the economics of owning Citibank stock to seek out alternative ways of gaining exposure.

* * *

The 2013 Proposed Regulations use a novel approach based on the theoretical concept of delta to determine whether an option is a specified ELI or not. This approach, as well as various rules included in the 2013 Proposed Regulations, raise complex and challenging issues with

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respect to listed options. The Coalition will continue to analyze the impact of the 2013 Proposed Regulations on listed options and may file supplemental comments.

Respectfully submitted,

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