

[4830-01-u]

DEPARTMENT OF TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-104641-97]

RIN 1545-AV48

Equity Options Without Standard Terms; Special Rules and Definitions

AGENCY: Internal Revenue Service (IRS), Treasury

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations providing guidance on the application of the rules governing qualified covered calls. The new rules address concerns that were created by the introduction of new financial instruments after the enactment of the qualified covered call rules. The proposed regulations will provide guidance to taxpayers holding qualified covered calls. This document also provides notice of public hearing on these proposed regulations.

DATES: Written comments must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION DATE OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Requests to speak (with outlines of oral comments) at the public hearing scheduled for November 4, 1998, must be submitted by October 14, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-104641-97), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered

between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-104641-97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Pamela Lew, (202) 622-3950; concerning submissions and the hearing, Michael L. Slaughter, Jr., (202) 622-7190, (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 1092(c) defines a straddle as offsetting positions with respect to personal property. Under section 1092(d)(3), stock is personal property if the stock is part of a straddle that involves an option on that stock or substantially identical stock or securities. Under section 1092(c)(4), however, writing a qualified covered call option and owning the optioned stock is not treated as a straddle for purposes of section 1092.

The special treatment for qualified covered calls was created because Congress believed that, in certain limited circumstances, a taxpayer who grants a call option does not substantially reduce his or her risk of loss with respect to the

optioned stock. Congress established a mechanical test to determine whether a written call option could substantially reduce a taxpayer's risk of loss and, therefore, should be subject to treatment as one leg of a straddle. In order to be classified as a qualified covered call under this test, a call option must, among other things, be exchange-traded and not be deep in the money.

Section 1092(c)(4)(C) defines a deep-in-the-money option as an option whose strike price is lower than an allowed bench mark. Under section 1092(c)(4)(D), this bench mark is generally the highest available strike price for an option that is less than the applicable stock price, as defined in section 1092(c)(4)(G). The Internal Revenue Code provides other bench marks under specified circumstances.

At the time the qualified covered call definition was written, listed options were available only at standardized maturity dates and strike price intervals. This fixed-interval system was a basic assumption of the Congressional plan for qualified covered calls and, more specifically, was the foundation for the definition of a deep-in-the-money option.

Certain options exchanges have begun to trade put and call equity options with flexible terms. The terms that are flexible include strike price, expiration date, and exercise style (that is, American, European, or capped). Except as noted below, the strike price is denominated in the smallest interval available on the options exchanges, which is currently 1/8 of one dollar. To

minimize the market impact of options contract expirations, equity options with flexible terms may not expire within 2 business days of equity options with standardized terms. Equity options with flexible terms are generally intended for institutional and other large investors.

Questions have been raised as to whether the strike prices established by equity options with flexible terms might establish the lowest qualified benchmark under section 1092(c)(4)(D) for all equity options, including those with standardized terms. The following example illustrates this concern. If a stock is currently selling for \$62, equity options with flexible terms and option periods of not more than 90 days could have a strike price of \$61 7/8. If the strike prices from equity options with flexible terms were taken into account in determining if a 90-day equity option with standardized terms is deep in the money, any option being sold for less than \$61 7/8 would be deep in the money. Because the strike prices for an equity option with standardized terms are set in \$5 intervals, the highest strike price less than the current selling price for an equity option with standardized terms would be \$60. Thus, any in-the-money equity option on the stock that had standardized terms would be deep in the money (for purposes of section 1092(c)(4)).

Explanation of Provisions

The proposed regulations provide that the strike prices established by equity options with flexible terms are not taken into account in determining whether equity options that are not

equity options with flexible terms are deep in the money. Thus, the existence of strike prices established for equity options with flexible terms does not affect the lowest qualified benchmark, as determined under section 1092(c)(4)(D), for an equity option with standardized terms. The proposed regulations define equity options with flexible terms as those equity options described in certain specified SEC releases, including any changes approved by the SEC to these releases.

The regulations will allow some taxpayers, primarily institutional and other large investors, to engage in certain exchange-based transactions that are currently unavailable to them and will permit other investors to continue doing business under section 1092 without regard to the existence of the institutional product.

The proposed regulations do not address whether an equity option with flexible terms is eligible for qualified covered call treatment under section 1092(c)(4). Comments are requested on the following issues: (1) whether equity options with flexible terms should be eligible for qualified covered call treatment under section 1092(c)(4); (2) whether there should be uniform rules governing the benchmarks for equity options with flexible terms and standardized options; and (3) if uniform rules are not appropriate, what benchmarks should apply to equity options with flexible terms.

Proposed Effective Date

These regulations apply to equity options with flexible terms entered into on or after the date that the Treasury Decision adopting these rules as final regulations is published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, November 4, 1998, beginning at 10:00 a.m. The hearing will be held in Room 2615, Internal Revenue Building, 1111 Constitution Avenue

NW., Washington DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments by [INSERT DATE 90 DAYS AFTER PUBLICATION DATE OF THIS DOCUMENT IN THE FEDERAL REGISTER] and submit an outline of topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 14, 1998.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Pamela Lew, Office of Assistant Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.1092(c)-1 also issued under 26 U.S.C.

1092(c)(4)(H). * * *

Par. 2. Section 1.1092(c)-1 is added to read as follows:

§1.1092(c)-1 Equity options with flexible terms.

(a) Effect on lowest qualified bench mark for other options.

The existence of strike prices established by equity options with flexible terms does not affect the determination of the lowest qualified bench mark, as defined in section 1092(c)(4)(D), for any option that is not an equity option with flexible terms.

(b) Definitions. For purposes of this section-

(1) Equity option with flexible terms means an equity option--

(i) That is described in the following Securities Exchange Act Releases--

(A) Self-Regulatory Organizations; Order Approving Proposed Rule Changes and Notice of Filing and Order Granting Accelerated Approval of Amendments by the Chicago Board Options Exchange, Inc. and the Pacific Stock Exchange, Inc., Relating to the Listing of Flexible Equity Options on Specified Equity Securities, Securities Exchange Act Release No. 34-36841 (Feb. 21, 1996); or

(B) Self-Regulatory Organizations; Order Approving Proposed Rule Changes and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 2 and 3 to the Proposed Rule Change by the American Stock Exchange, Inc., Relating to the Listing of Flexible Equity Options on Specified Equity Securities, Securities Exchange Act Release No. 34-37336 (June 27, 1996); or

(C) Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 2, 4 and 5 to the Proposed Rule Change by the Philadelphia Stock Exchange, Inc., Relating to the Listing of Flexible Exchange Traded Equity and Index Options, Securities Exchange Act Release No. 34-39549 (Jan. 23, 1998); or

(D) Any changes to the SEC releases described in paragraphs (b)(1)(i)(A) through (C) of this section that are approved by the Securities and Exchange Commission; or

(ii) That is traded on any national securities exchange which is registered with the Securities and Exchange Commission (other than those described in the SEC Releases set forth in paragraph (b)(1)(i) of this section) or other market which the Secretary determines has rules adequate to carry out the purposes of section 1092 and is--

(A) Substantially identical to the equity options described in paragraph (b)(1)(i) of this section; and

(B) Approved by the Securities and Exchange Commission in a Securities Exchange Act Release.

(2) Securities Exchange Act Release means a release issued by the Securities and Exchange Commission. To determine identifying information for releases referenced in paragraph (b)(1) of this section, including release titles, identification numbers, and issue dates, contact the Office of the Secretary, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549. To obtain a copy of a Securities Exchange Act Release, submit a written request, including the specific release identification number, title, and issue date, to Securities and Exchange Commission, Attention Public Reference, 450 5th Street, NW., Washington, DC 20549.

(c) Effective Date. These regulations apply to equity options with flexible terms entered into on or after the date that the Treasury Decision adopting these regulations is published in the **Federal Register**.

Deputy Commissioner of Internal Revenue