

[4830-01-u]

DEPARTMENT OF TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8866]

RIN 1545-AV48

Equity Options With Flexible Terms; Special Rules and Definitions

AGENCY: Internal Revenue Service (IRS), Treasury

ACTION: Final regulations.

SUMMARY: This document contains final 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 final regulations will provide guidance to taxpayers writing qualified covered calls.

EFFECTIVE DATE: These regulations are effective January 25, 2000.

FOR FURTHER INFORMATION CONTACT: Pamela Lew of the Office of Assistant Chief Counsel (Financial Institutions and Products), (202) 622-3950 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On June 25, 1998, the IRS published in the **Federal Register** proposed regulations (REG-104641-97, 63 FR 34616) addressing whether strike prices available for equity options with flexible terms affect the definition of a qualified covered call (QCC)

under section 1092(c)(4) for equity options with standardized terms. No requests to speak at a public hearing were received, and no public hearing was held.

Two written comments were received. These comments focused on whether equity options with flexible terms should be eligible for QCC treatment. After considering these comments, the IRS and Treasury have decided to address the eligibility of equity options with flexible terms and certain other equity options for QCC treatment in other forthcoming guidance.

One of the comments also suggested a clarifying change to the text of the proposed regulations. After revising the regulation to take into account this comment, the proposed regulations are adopted by this Treasury decision.

#### **Explanation of Provisions**

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 QCC option and owning the optioned stock is not treated as a straddle for purposes of section 1092.

In order to be a QCC, a call option must, among other things, be exchange-traded and not be deep in the money. An option is deep in the money if the strike price of the option is lower than the lowest qualified bench mark for the stock. This

bench mark is generally the highest available strike price for an option on the stock that is less than the applicable stock price.

At the time the QCC provisions were enacted, exchange-traded 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 QCCs and, more specifically, was the foundation for the definition of a deep-in-the-money option.

Certain options exchanges have begun to trade equity options with flexible terms. Unlike standardized exchange-traded options, these options could have strike prices at other than fixed intervals. For this reason, there is concern that the strike prices established for equity options with flexible terms could impact the bench-mark system for standardized exchange-traded options.

The proposed regulations provide that strike prices established by equity options with flexible terms are not taken into account in determining whether options that are not equity options with flexible terms are deep in the money. Thus, the existence of strike prices established by equity options with flexible terms does not affect the lowest qualified bench mark, as determined under section 1092(c)(4)(D), for an equity option with standardized terms.

One commentator was concerned that usage of the phrase "existence of strike prices established by equity options without standardized terms" might be interpreted as requiring actual

trading at a particular strike price. The commentator suggested that the regulation be modified to discuss the availability of a strike price for equity options with flexible terms rather than the existence of a strike price established by equity options with flexible terms. This suggestion has been incorporated into the final regulation.

### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 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, the notice of proposed rulemaking was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **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.

**Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 1 is 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) In general. Section 1092(c)(4) provides an exception to the general rule that a straddle exists if a taxpayer holds stock and writes a call option on that stock. Under section 1092(c)(4), the ownership of stock and the issuance of a call option meeting certain requirements result in a qualified covered call, which is exempted from the general straddle rules of section 1092. This section addresses the consequences of the availability of equity options with flexible terms under the qualified covered call rules.

(b) No effect on lowest qualified bench mark for standardized options. The availability of strike prices for 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 an option that is not an equity option with flexible terms.

(c) [Reserved].

(d) Definitions. For purposes of this section-

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

(i) That is described in any of 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 (d)(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 (d)(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 (d)(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 (d)(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.

(e) Effective date. These regulations apply to equity options with flexible terms entered into on or after January 25, 2000.

Robert E. Wenzel

Deputy Commissioner of Internal Revenue

Approved: 1/17/2000

Jonathan Talisman

Acting Assistant Secretary of the Treasury