

## Notice of Proposed Rulemaking and Notice of Public Hearing

### Equity Options with Flexible Terms; Qualified Covered Call Treatment

#### REG-115560-99

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 several years after the enactment of the qualified covered call rules. The proposed regulations would provide guidance to taxpayers writing equity call op-

tions. This document also provides notice of public hearing on these proposed regulations.

DATES: Written and electronic comments and requests to appear and outlines of topics to be discussed at the public hearing scheduled for May 9, 2001, at 10 a.m., must be submitted by April 18, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG-115560-99), room 5226, 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:M&SP:RU (REG-115560-99), 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 of the IRS Home Page, or by submitting comments directly to the IRS Internet site at [http://www.irs.gov/tax\\_regs/regslst.html](http://www.irs.gov/tax_regs/regslst.html). The public hearing will be held in the IRS Auditorium, 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, Guy Traynor, (202) 622-7180, (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

#### Background

On June 25, 1998, the IRS published in the **Federal Register** proposed regulations (REG-104641-97, 1998-2 C.B. 75 [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.

The proposed regulations provided that strike prices available for equity options with flexible terms do not affect the benchmarks used to determine whether equity options with standardized terms are eligible for QCC treatment. That provision was adopted as §1.1092(c)-1 of the final regulations (T.D. 8866, 2000-6 I.R.B.

495), published in the **Federal Register** for January 25, 2000 (65 F.R. 3812).

The regulatory text of REG-104641-97 did not address whether an equity option with flexible terms is itself eligible for QCC treatment. The preamble to the proposed regulations, however, did request comments about whether equity options with flexible terms should be eligible for QCC treatment and, if eligible, what benchmarks should apply. In light of the comments received, consideration was also given to the treatment of over-the-counter options and standardized options with terms of more than one year. After consideration of the written comments, this NPRM proposes regulations addressing the eligibility for QCC treatment of equity options with flexible terms, over-the-counter options and standardized options with terms longer than one year.

#### QCC Treatment

Section 1092(c) defines a straddle as offsetting positions with respect to personal property. Under section 1092(d)(3)(B)(i)(I), 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 under section 1092 if certain conditions are satisfied.

The legislative history of section 1092 indicates that QCCs were excepted from the loss deferral rule for straddles because "they are undertaken primarily to enhance the taxpayer's investment return on the stock and not to reduce the taxpayer's risk of loss on the stock." H.R. Rep. No. 432, 98th Cong., 2d Sess. at 1266-68 (1983). To qualify as a QCC, a covered call must, among other things, be exchange traded and not be deep in the money. An option is exchange traded if the option is traded on a national securities exchange that is registered with the Securities and Exchange Commission or on some other market that the Secretary determines has rules adequate to carry out the purposes of the QCC provisions. An option is deep in the money if the strike price of the option is lower than the lowest qualified benchmark for the stock at the time the option is written.

Section 1092(c)(4)(H) grants the Secretary of the Treasury the authority to prescribe regulations to carry out the purposes of the QCC exception, including regulations modifying the provisions of the exception as appropriate to take account of changes in the practices of options exchanges.

The introduction of exchange-traded equity options with flexible terms is one such change. Unlike equity options with standardized terms, equity options with flexible terms can have strike prices at other than fixed intervals and have other than standardized expiration dates. Options exchanges have also introduced standardized options with longer terms.

In response to the request for comments, two comments were received. One commentator argued that equity options with flexible terms should not be eligible for QCC treatment. This commentator noted that in 1984, when section 1092(c)(4) was enacted, only equity options with standardized terms were traded on the national exchanges and that it is likely that Congress did not intend to include customizable options within the definition of a QCC. This commentator also pointed out that equity options with flexible terms were developed to compete with over-the-counter (OTC) options, which are not eligible for QCC treatment. The commentator suggested that excluding equity options with flexible terms from QCC treatment would avoid a competitive imbalance from different tax treatment for competing products.

The second commentator stated that, as a matter of statutory analysis, equity options with flexible terms are already eligible for QCC treatment. This commentator argued that QCC treatment is appropriate if the taxpayer is using the option to increase the yield on its stock investment and not to reduce the risk of loss on its stock. In support of this point, the commentator noted that nothing in the applicable legislative history suggests that Congress intended to limit the QCC option exception to standardized options. Alternatively, this commentator argued that because equity options with flexible terms were designed to compete with OTC options, regulations should be promulgated allowing OTC options to qualify for QCC treatment on the same terms

as exchange-traded equity options with flexible terms.

### **Explanation of Provisions**

#### *Equity Options with Flexible Terms and Qualifying OTC Options*

After consideration of the comments received, the proposed regulations provide that equity options with flexible terms may be QCC options as long as they satisfy the general rules for QCC treatment described in section 1092(c)(4), are not for a term of longer than one year, and meet other specified requirements. In addition, an equity option with standardized terms must be outstanding for the underlying equity. For purposes of applying the general rules, the bench marks will be the same as those for an equity option with standardized terms on the same stock having the same applicable stock price.

The proposed regulations also provide that certain OTC options may be QCC options so that OTC options that are economically similar to equity options with flexible terms may enjoy the same tax benefits as equity options with flexible terms. Specifically, the proposed regulations provide that an OTC option is eligible for QCC treatment if it is entered into with a person registered with the Securities and Exchange Commission as a broker-dealer or alternative trading system and meets the same requirements for QCC treatment that apply to equity options with flexible terms.

#### *QCC Status for Equity Options with Standardized Terms*

In the process of considering the proper treatment for equity options with flexible terms, the IRS examined QCC status in general. At the time that Congress enacted section 1092(c)(4), options available on the national securities exchanges had a term of nine months or less. Congress did not include in the legislative history any guidance on the effect of the time value of money upon the strike price.

Subsequent to the enactment of section 1092(c)(4), the national securities exchanges began offering certain standardized options with expiration dates that are 12 or more months after the date entered into. The longer term of these options may reduce the taxpayer's risk of loss on its stock position because of the time pe-

riod involved.

Increased risk reduction through the use of long term options applies equally to equity options with flexible terms, OTC options, and equity options with standardized terms. The proposed regulations therefore provide that a one-year term limit also applies to equity options with standardized terms. Comments are requested on this issue, including a discussion of time limitations in general, as well as the appropriateness of a one-year cutoff.

If QCC treatment should apply to longer-term options, it may be appropriate to change the deep-in-the-money standard to prevent the increase in risk reduction. A comment recommending a time limitation greater than one year or recommending that there be no time limitation should also provide detailed, comprehensive descriptions of possible solutions to the problem of increased risk reduction. Comments should also address the administrability of any proposed solutions.

### **Proposed Effective Date**

These regulations would apply to options entered into on or after 30 days after the date that the Treasury decision adopting these rules as final regulations is published in the **Federal Register**.

Regulations concerning time limitations for equity options with standardized terms would be prospective in nature and would apply to transactions entered into on or after 90 days from the date of publication of the final regulation promulgating such rules.

### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that these regulations do not impose any recordkeeping or reporting requirements and therefore impose minimal compliance costs, if any, upon any small entities that may be affected. Because equity options with standardized terms will not be eligible for QCC treatment if such options have a duration of more than 1 year, some

taxpayers may lose substantive tax benefits. This certification is further based upon the understanding that such taxpayers will not include a substantial number of small entities. Comments are specifically requested on the question of whether a substantial number of small entities (as opposed to large entities or individual investors) will suffer a significant economic impact under these regulations. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. 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 or electronic comments (a signed original and eight (8) copies, if written) that are submitted timely (in the manner described in the ADDRESSES portion of this preamble) to the IRS. The IRS and Treasury request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 9, 2001, at 10 a.m., in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW, Washington DC. Due to building security procedures, visitors must enter at the 10th Street entrance located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identifications to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

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 and an outline of the topics to be discussed and the time to be devoted to each topic

(signed original and eight (8) copies) by April 18, 2001. 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 Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury Department participated in their development.

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### 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 entries in numerical order to read as follows:

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

Section 1.1092(c)-2 also issued under 26 U.S.C.1092(c)(4)(H)

Section 1.1092(c)-3 also issued under 26 U.S.C. 1092(c)(4)(H). \* \* \*

Par. 2. Section 1.1092(c)-1 is amended as follows:

1. Paragraphs (b) and (d)(1)(ii) introductory text are revised.

2. Paragraphs (c) and (d)(3) are added.

3. Paragraph (e) is revised.

The revisions and addition read as follows:

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

\* \* \* \* \*

(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 equity option with standardized terms.

(c) *Qualified covered call option status—(1) Requirements.* An equity option with flexible terms is a qualified covered call option only if—

(i) The option meets the requirements of section 1092(c)(4)(B) (taking into account paragraph (c)(2) of this section);

(ii) The only payments permitted with respect to the option are a single fixed premium paid not later than 5 business days after the day on which the option is granted, and a single fixed strike price stated as a dollar amount that is payable entirely at (or within 5 business days of) exercise;

(iii) The option is granted not more than 1 year before the day on which the option expires; and

(iv) An equity option with standardized terms is outstanding for the underlying equity.

(2) *Lowest qualified bench mark—(i) In general.* For purposes of determining whether an equity option with flexible terms is deep in the money within the meaning of section 1092(c)(4)(C), the lowest qualified bench mark under section 1092(c)(4)(D) is the same for an equity option with flexible terms as the lowest qualified bench mark for an equity option with standardized terms on the same stock having the same applicable stock price.

(ii) *Example.* The following example illustrates the rules set out in paragraph (c)(2)(i) of this section:

*Example.* Taxpayer owns stock in Corporation X. Taxpayer writes an equity call option with flexible terms on Corporation X stock through a national securities exchange. The applicable stock price for Corporation X stock is \$73.75. Using the bench marks for an equity option with standardized terms with an applicable stock price of \$73.75, the highest available bench mark less than the applicable stock price is \$70, and the second highest bench mark is \$65. Therefore, an equity call option with flexible terms on Corporation X with a term of 90 days or less will not be deep in the money if the strike price is not less than \$70. If the term is greater than 90 days, an equity call option with flexible terms on Corporation X will not be deep in the money if the strike price is not less than \$65.

(d) \* \* \*

(1) \* \* \*

(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) and is—

\* \* \* \* \*

(3) *Equity option with standardized terms* means an equity option that is traded on a national securities exchange registered with the Securities and Ex-

change Commission and that is not an equity option with flexible terms.

(e) *Effective date*—(1) *In general.* Except as provided in paragraph (e)(2) of this section, this section applies to equity options with flexible terms entered into on or after January 25, 2000.

(2) *Special effective date for paragraph (c).* Paragraph (c) of this section applies to equity options with flexible terms entered into on or after 30 days after the date that the Treasury decision adopting these regulations is published in the **Federal Register**.

Par. 3. Section 1.1092(c)–2 is added to read as follows:

*§1.1092(c)–2 Equity options with standardized terms.*

(a) *One-year limitation.* An equity option with standardized terms (as defined in §1.1092(c)–1(d)(3)) is a qualified covered call only if—

(1) The option meets the requirements of section 1092(c)(4)(B); and

(2) The option is granted not more than 1 year before the day on which the option expires.

(b) *Effective date.* This section applies to equity options with standardized terms entered into on or after 90 days after the date that the Treasury decision adopting these regulations is published in the **Federal Register**.

Par. 4. Section 1.1092(c)–3 is added.

*§1.1092(c)–3 Qualifying over-the-counter options.*

(a) *In general.* Under section 1092(c)(4)(B)(i), an equity option is not a qualified covered call option unless it is traded on a national securities exchange which is registered with the Securities and Exchange Commission or other market which the Secretary determines has rules adequate to carry out the purposes of section 1092(c)(4). In accordance with section 1092(c)(4)(H), this requirement is modified as provided in paragraph (b) of this section.

(b) *Qualified covered call option status.* A qualifying over-the-counter option is a qualified covered call option if it meets the requirements of §1.1092(c)–1(c) after substituting “qualifying over-the-counter option” for “equity option with flexible terms”. For the purposes of this paragraph (b), a qualifying over the counter option is deemed to satisfy the requirements of sec-

tion 1092(c)(4)(B)(i).

(c) *Qualifying over-the-counter option.* For the purposes of this section, *qualifying over-the-counter option* means an equity option that—

(1) Is not traded on a national securities exchange registered with the Securities and Exchange Commission; and

(2) Is entered into with a person registered with the Securities and Exchange Commission as—

(i) A broker-dealer under section 15 of the Securities Act of 1934 and the regulations thereunder; or

(ii) An alternative trading system under 17 CFR 242.300 *et seq.*

(d) *Effective date.* This section applies to qualifying over-the-counter options entered into on or after 30 days after the date that the Treasury decision adopting these regulations is published in the **Federal Register**.

Robert E. Wenzel,  
Deputy Commissioner  
of Internal Revenue.

(Filed by the Office of the Federal Register on January 17, 2001, 8:45 a.m., and published in the issue of the Federal Register for January 18, 2001, 66 F.R. 4751)