Section 1092.—Straddles

26 CFR 1.1092(c)–1: Qualified covered call options.
(Also § 263; 1.1092(c)–2; 1.1092(c)–3; 1.1092(c)–4.)

Effect of collars on qualified covered calls. Guidance is provided under section 1092 of the Code regarding the effect of collars upon qualified covered call options.

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ISSUE

If the grantor of a qualified covered call option holds a put option on the same underlying equity, is the straddle consisting of the underlying equity and the written call option part of a larger straddle and therefore not excluded from straddle treatment by § 1092(c)(4)(A) of the Internal Revenue Code?

FACTS

In each of the following situations, assume that:

1) at the time the call option is written and at the time the put option is acquired, there is an inverse relationship between the value of the underlying equity and the value of each option position;

2) as a result of the magnitude of the inverse relationships, each option position substantially diminishes the risk arising from holding the equity;

3) The acquisition of the put option substantially diminishes the risk of loss with respect to the combined position consisting of the equity and the qualified covered call option on that equity; and

4) the call option is a qualified covered call option under § 1092(c)(4)(B).

Situation 1. On August 1, 2002, *A* purchases 100 shares of Corporation *X* stock for $100 per share, writes a 12-month call option on 100 shares of *X* stock with a strike price of $110, and purchases a 12-month put option on 100 shares of *X* stock with a strike price of $100.

Situation 2. On September 3, 2002, *B* purchases 100 shares of Corporation *Y* stock for $102 per share. On September 6, 2002, when the fair market value of *Y* stock is $100, *B* writes a 12-month call option for 100 shares of *Y* stock with a strike price of $110 and purchases a 12-month put option on 100 shares of *Y* stock with a strike price of $100.

Situation 3. On October 1, 2002, *C* purchases 100 shares of Corporation *Z* stock for $102 per share. On October 3, 2002, when the fair market value of *Z* stock is $100, *C* writes a 12-month call option on 100 shares of *Z* stock with a strike price of $110. On December 2, 2002, when the fair market value of the *Z* stock remains $100, *C* purchases a 12-month put option on 100 shares of *Z* stock with a strike price of $100.

LAW AND ANALYSIS

Section 1092(a) limits the recognition of losses on one or more positions in a straddle to the amount by which the losses exceed the unrecognized gain in any offsetting positions in that straddle. Section 1092(c) defines a straddle as offsetting positions with respect to personal property, and § 1092(d)(3) treats stock as personal property if the stock is a position in the straddle and an option on that stock or on substantially identical stock or securities is an offsetting position in that straddle.

Section 1092(c)(4)(A) provides that a straddle will not be treated as a straddle for purposes of §§ 1092 or 263(g) if:

(i) all of the offsetting positions making up any straddle consist of one or more qualified covered call options and the stock to be purchased from the taxpayer under such options, and

(ii) such straddle is not part of a larger straddle. The two clauses of § 1092(c)(4)(A) work together to delineate the scope of the exemption from straddle treatment provided by § 1092(c)(4). Clause (i) requires that, in order to obtain this exemption with respect to a given straddle, the straddle must consist only of one or more qualified covered call options and the stock to be purchased from the taxpayer under the options. Even if this requirement is satisfied, however, clause (ii) precludes the exemption from applying if the taxpayer holds at least one other position (*i.e.*, a position other than qualified covered call options and the stock to be purchased thereunder) that, when considered together with the stock and qualified covered call options described in clause (i), creates a larger straddle.

Neither the statutory language nor the legislative history of § 1092(c)(4) defines the term "part of a larger straddle." Section 1092(a)(2)(B)(iii) uses the same phrase in the definition of an identified straddle but does not define the term "larger straddle." The legislative history to § 1092(a)(2)(B)(iii) also does not define the term but does state that "[i]n addition, an identified straddle cannot constitute part of a larger straddle (for example, a butterfly)." S. Rep. No. 144, 97th Cong., 1st Sess. 148 (1981), 1981–2 C.B. 412, 471. An example of a "butterfly" is a commodity straddle consisting of a 5 unit short position expiring in May 2002, a 10 unit long position expiring in June 2002, and a 5 unit short position expiring in July 2002. The relationship among the three positions in a butterfly is explained in *Leslie v. Commissioner,* T.C. Memo 1996–86, *aff'd,* 146 F.3d 643 (9th Cir. 1998), *cert. denied,* 525 U.S. 1071 (1999):

> The center position or body of a butterfly spread is twice as large as either wing, and the time periods for the delivery of the commodity from the first wing to the body and from the body to the second wing are equal. Essentially, a butterfly spread creates two spreads, one bullish and one bearish. Thus, a butterfly spread presents less chance of either an adverse or a favorable spread movement and is, therefore, less likely to result in a different loss or gain than an ordinary straddle.

The 1981 legislative history to § 1092(a)(2)(B)(iii), while not directly applicable to § 1092(c)(4), supports the treatment of a qualified covered call option as being "part of a larger straddle" if the taxpayer holds one or more additional positions that substantially diminish the risk of holding the equity by itself and the risk of the combination of holding the equity and writing the qualified covered call option.

The legislative history of the qualified covered call option exception to § 1092 straddle treatment does not clarify the meaning of the phrase "larger straddle" but does discuss considerations underlying the decision to create the exemption. The report of the House Committee on Ways and Means contains this explanation:

> One widely used investment strategy that would be affected by the extension of the straddle rules to stock options and stock involves writing call options on stock owned by the taxpayer. The committee believes that it may be appropriate to exempt these transactions where 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. 1266 (1984).

In the three situations described above, the presence of a purchased put substantially reduces the taxpayer's risk of loss with respect to the stock, and also reduces any potential for enhancing the taxpayer's investment return through premium income. In each of the three situations, the put option protects against a decrease in the value of the stock below the exercise price of the put option and also reduces the impact of changes in the value of the stock through the inverse relationship between the value of the stock and the value of the put option. Both factors substantially diminish the risk of loss with respect to the holding of the stock by itself and the risk of loss with respect to the combination of the stock and the written qualified covered call option. In addition, when the owner of the stock acquires the put, the amount of the premium received from the call option is offset, in whole or in part, by the amount of the premium paid for the put option, thus reducing any potential enhancement of investment return on the stock resulting from the receipt of the call option premium. In effect, when the writer of the call option purchases the put, the writer gives up potential enhancement of return on investment to acquire additional risk protection.

Accordingly, in each of the three situations described above, the presence of the purchased put causes the stock and the qualified covered call option to constitute part of a larger straddle within the meaning of § 1092(c)(4)(A).

HOLDINGS

Situation 1. All of the positions in *X* stock are treated as part of a larger straddle. Section 1092(c)(4) does not apply to any of the positions in *X* stock.

Situation 2. All of the positions in *Y* stock are part of a larger straddle beginning on September 6, 2002. Section 1092(c)(4) does not apply to any of the positions in *Y* stock beginning on that date.

Situation 3. Prior to December 2, 2002, the combination of the qualified covered call option and the underlying shares are not treated as a straddle for purposes of §§ 1092 and 263(g). However, beginning on December 2, 2002, all of the positions in *Z* stock are part of a larger straddle, and § 1092(c)(4), therefore, does not apply to any of the positions in *Z* stock beginning on that date.

DRAFTING INFORMATION

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