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## The Federal Taxation of Options Investors: An Examination of Sections 1091, 1233 and 1234 for Their Implications and Tax-Planning Potential

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# The Federal Taxation of Options Investors: An Examination of Sections 1091, 1233 and 1234 for Their Implications and Tax-Planning Potential

This article will examine the federal tax aspects of puts, calls, and straddles. During the past few years<sup>1</sup> these options have dropped out of the financial world's "lunatic fringe" and joined the respectable grey-flanneled mainstream. This new status is due in part to the fact that despite centuries<sup>2</sup> or perhaps millenia<sup>3</sup> of widespread use, it was not until the Chicago Board of Options Exchange (CBOE) opened its doors on April 26, 1973<sup>4</sup> that a ready market for call options was available to investors. Since that time both the volume of trading and the number of exchanges increased significantly. Currently, the American Exchange, Philadelphia, Baltimore and Washington Exchange, and Pacific Exchange also trade calls.<sup>5</sup> Further, although the Securities and Exchange Commission recently denied the CBOE's request for permission to trade puts,<sup>6</sup> there is every reason to believe that such permission will be forthcoming in the near future.<sup>7</sup> It appears that as exchange options

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1. In 1959 there were only 15 active broker-dealer firms and under 600 writers of puts and calls. SEC REPORT ON PUT AND CALL OPTIONS 54, 63 (1961).

2. One of the more colorful incidents in the long history of option trading occurred during the Dutch Tulip Bulb mania. During the first part of the seventeenth century, the Dutch developed a futures market in tulip bulbs. Growers of the bulbs bought puts to insure minimum prices and then sold calls to dealers. Dealers in bulbs sold the bulbs at prices which reflected the calls written by the growers. Unfortunately, there was no financially responsible intermediary such as the Options Clearing Corporation to assure that the writers of the options fulfilled their contractual obligations. Similarly, no margin requirements existed to keep leverage at a tolerable level. The market collapsed in 1636, simultaneously breaking the writers of puts and tarnishing the name of options for over 300 years. C. MACKAY, EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS (1969); G. GASTINEAU, THE STOCK OPTIONS MANUAL 16-17 (1975).

3. In *The Politics*, Aristotle recounts a story which shows that options were known among the ancient Greeks:

[Thales] deducing from his knowledge of the stars that there would be a good crop of olives, while it was still winter raised a little capital and used it to pay deposits on all the oil-presses in Miletus and Chios, thus securing an option on their hire. This cost him only a small sum as there were no other bidders. Then the time of the olive-harvest came and as there was a sudden and simultaneous demand for oil-presses, he hired them out at any price he liked to ask.

ARISTOTLE, *THE POLITICS*, Book 1, ch. 11 (T. Sinclair transl. 1962).

4. Gallagher & Tarkoe, *Taxing an Option on American Business: Puts, Calls and the IRC*, 52 TAXES 481 (1974).

5. Wall Street Journal, Aug. 5, 1976, at 17, col. 2.

6. Letter from SEC Chairman Hills to CBOE President Sullivan, July 7, 1976 (copy on file in Loyola University of Chicago Law Journal Office). See also Wall Street Journal, Sept. 14, 1976, at 8, col. 2.

7. The Securities and Exchange Commission has stated:

grow more popular among investors most attorneys will need at least a modicum of expertise in this area of taxation.

The insular world of options has developed its own patois. Consequently, it may be helpful to begin this article with a few definitions. An option is a contract to buy or sell a specific number of shares of stock within a fixed period of time for a set price. A contract to sell is termed a put. A contract to buy is termed a call. A call

gives the holder the right to buy the number of shares or other units of the underlying security covered by the Option . . . at the stated exercise price . . . [at any time prior to the option's expiration date].<sup>8</sup>

The aforementioned exercise price is "the price per unit at which the holder of an Option may purchase the underlying security upon exercise."<sup>9</sup> This is also referred to as the striking price. The consideration paid by the holder of the option to the grantor of the option is termed the premium. The premium is the "aggregate price of the Option agreed upon between the buyer (holder) and writer."<sup>10</sup> Finally, when the taxpayer writes two options, one a put and one a call, and when these options have identical underlying stock, contract price and date of expiration, the taxpayer has written a straddle.<sup>11</sup>

Puts, calls, and straddles are the three forms of options upon which this article will concentrate. Three sections of the Internal Revenue Code of 1954 are particularly relevant where these options are concerned: section 1091 on wash sales, section 1233 on short sales, and section 1234 which deals with options themselves. Each of these sections will be discussed separately. Afterwards, they will be integrated for the purposes of examining both their impact upon various transactions and their tax-planning potential. In addition, the changes wrought by the Tax Reform Act of 1976 will be considered. However, before this examination and integration the taxpayers themselves must be analyzed, since the status of the taxpayer will determine the tax treatment of the various transactions.

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[W]hile no decision has been made on the initiation of puts trading or on the related exchange rule proposals, we recognize the economic logic for the extension of existing exchange option trading to include puts.

*Id.*

8. THE OPTIONS CLEARING CORPORATION, PROSPECTUS 1 (1975).

9. *Id.*

10. *Id.*

11. Treas. Reg. § 1.1234-2(b)(1) (1974).

## TAXPAYER'S STATUS

A taxpayer may fall into one of three mutually exclusive categories: dealer, trader, or investor.<sup>12</sup> Unfortunately, these categories are so broadly defined that it is not easy to pigeonhole all taxpayers.<sup>13</sup> However, ascertaining a taxpayer's status is essential. For example, status determines the treatment of the taxpayer under sections 1091, 1233, and 1234.<sup>14</sup> While this article concentrates on those taxpayers who are investors, the definitions and tests supplied by the Service and the courts for dealers and traders will be examined as well.

*Dealers*

Treasury Regulations define a dealer as a

merchant of securities, whether an individual partnership, or corporation with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom.<sup>15</sup>

The phrase within the definition which has been stressed by the courts is "sells . . . to customers with a view to the gains and profits that may be derived therefrom."<sup>16</sup> The importance of the phrase is derived from the Code's definition of a capital asset. Section 1221 provides:

[T]he term capital asset means property held by the taxpayer . . . but does not include . . . property held by the taxpayer for sale to customers in the ordinary course of his trade or business.

Accordingly, stocks and securities are not capital assets in the hands of a dealer. Hence, their sale or exchange results in ordinary gains and losses.<sup>17</sup>

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12. 3b MERTENS, LAW OF FEDERAL TAXATION § 22.153, at 1085 (1973).

13. *Id.* at 1084.

14. Section 1234 has been amended by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2136 (Oct. 4, 1976), and now clearly distinguishes between those taxpayers who carry out options transactions as part of their trade or business and those taxpayers who do not.

15. Treas. Reg. § 1.471-5 (1958). Reference to this regulation is made by Treas. Reg. § 1.1236-1(c)(2) (1964).

16. *Factor v. Commissioner*, 281 F.2d 100 (9th Cir. 1960), *cert. denied*, 364 U.S. 933 (1961). Some earlier decisions phrased the test as being whether the taxpayer "purchased securities and held them, not for investment or speculation, but for resale at a profit to anyone who desired to buy." *Commissioner v. Charavay*, 79 F.2d 406 (3d Cir. 1935); *Securities Allied Corp. v. Commissioner*, 95 F.2d 384 (2d Cir.), *cert. denied*, 305 U.S. 617 (1938).

17. A taxpayer may be a dealer with respect to some securities but an investor with respect to others. *Schafer v. Helvering*, 299 U.S. 171 (1936). The Service has examined this situation in so far as it applies to "specialists" in two revenue rulings: Rev. Rul. 60-321, 1960-

Due to the importance of sales to customers when determining the taxpayer's status, the courts have stressed the Treasury Regulation's merchant analogy. The more closely a taxpayer approximates a merchant, the more likely he is to be considered a dealer. The courts and the Service have found the following factors indicative of dealership: being licensed as a dealer,<sup>18</sup> large volume of sales and purchases,<sup>19</sup> selling shares out of an inventory to customers,<sup>20</sup> holding oneself out to the public as a dealer,<sup>21</sup> profiting from dealer's commissions rather than from appreciation in the value of the shares,<sup>22</sup> leasing space on the floor of an exchange<sup>23</sup> and membership in an exchange.<sup>24</sup> While each of these elements is important, none alone is sufficient to establish the taxpayer as a dealer. Whenever the taxpayer desires to achieve dealership status he should acquire as many of these characteristics as possible. Failure to acquire even a few of these attributes may result in a denial of dealership status. For example, even those taxpayers who "deal" extensively in stock and securities are not dealers if they seek to profit from speculation rather than from the resale of the items as part of their inventory.<sup>25</sup> Similarly, taxpayers who act as intermediaries, buying and selling

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2 CUM. BULL. 166 and Rev. Rul. 71-30, 1971-1 CUM. BULL. 226. Rev. Rul. 60-321 adopts the position of *Helvering v. Fried*, 299 U.S. 175 (1936). It considers "specialists" to be dealers as they fill orders from their own securities or by matching orders of buyers and sellers, generally have securities on hand, lease space on the exchange floor and regularly engage in the business of purchase and resale.

Rev. Rul. 71-30 adopts the position of SEC REPORT OF SPECIAL STUDY SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 95 PT. 2, 88th Cong., 1st Sess. 47 (1963) and gives as its definition:

an exchange member who stays continuously at one post, and participates in trading as both a dealer and a broker, in the stocks in which he is registered with the exchange as a specialist. As a broker, the specialist receives orders for the purchase and sale of specialty stock from other brokers and holds the orders for execution when the market moves to the price specified in the order. As a dealer, he buys or sells specialty stock for his own account at a fair price to the extent necessary to maintain a "fair and orderly market."

18. Frank B. Polachek, 22 T.C. 858 (1954).

19. Reinach v. Commissioner, 373 F.2d 900, 901 (2d Cir. 1967).

20. United States v. Chinook Invest. Co., 136 F.2d 984 (9th Cir. 1943). However, merely because the taxpayer makes a single large sale to a customer does not ipso facto make him a dealer. See *Bradford v. United States*, 444 F.2d 1133, 1141 (Ct. Cl. 1971). *But cf.* *Nielsen v. United States*, 333 F.2d 615 (6th Cir. 1964).

21. Frank W. Verito, 43 T.C. 429 (1965).

22. George R. Kemon, 16 T.C. 1026, 1032-33 (1951); accord, *Brown v. United States*, 426 F.2d 355, 364 (Ct. Cl. 1970).

23. *Cf.* *Synder v. Commissioner*, 295 U.S. 134 (1935).

24. *Helvering v. Fried*, 299 U.S. 175 (1936); *Securities Allied Corp. v. Commissioner*, 95 F.2d 384 (2d Cir. 1938).

25. *Higgins v. Commissioner*, 312 U.S. 212 (1941); *Commissioner v. Burnett*, 118 F.2d 659 (5th Cir. 1941).

stock at the command of their client, are not dealers<sup>26</sup> despite a large volume of purchases and sales.

### *Trader*

The term trader is not defined in either the Code or the Regulations. Its clearest definition was enunciated in *George R. Kemon*,<sup>27</sup> where the court stated:

Contrasted to "dealers" are those sellers of securities who perform no . . . merchandising functions and whose status as to the source of supply is not significantly different from that of those to whom they sell. That is, the securities are easily accessible to one as to the other and the seller performs no services that need be compensated for by a mark-up of the price of the securities he sells. The sellers depend upon such circumstances as a rise in value or an advantageous purchase to enable them to sell at a price in excess of cost. Such sellers are known as traders.<sup>28</sup>

The courts have regarded the following factors as indicative of trader status: a large and continuous volume of sales and purchases,<sup>29</sup> purchasing through a broker,<sup>30</sup> lack of membership on any exchange,<sup>31</sup> a large amount of time devoted to the investments,<sup>32</sup> holding the securities for only a short period of time,<sup>33</sup> and not being licensed to sell securities to customers.<sup>34</sup>

When a taxpayer gains trader status, he acquires two major advantages. First, his sales generate capital gains and losses.<sup>35</sup> Second, section 212 permits him considerable itemized deductions.<sup>36</sup> As a

26. *Edward A. Neuman de Vegvar*, 28 T.C. 1055 (1957).

27. 16 T.C. 1026 (1951).

28. *Id.* at 1033; *accord*, *Bradford v. United States*, 444 F.2d 1133, 1141 (Ct. Cl. 1971).

29. *James M. Ferguson, Sr.*, 33 CCH Tax Ct. Mem. 1082 (1974).

30. *Faroll v. Jarecki*, 231 F.2d 281, 287 (7th Cir. 1956).

31. *Cf. Bradford v. United States*, 444 F.2d 1133, 1141 (Ct. Cl. 1971).

32. *Chemical Bank and Trust Co. v. United States*, 21 F. Supp. 167 (Ct. Cl. 1937).

33. *Compare Jack W. Schiffer*, 39 B.T.A. 161, 164 (1939) with THE NEW YORK STOCK EXCHANGE, THE LANGUAGE OF INVESTING 33 (1974) which states that a trader is "[o]ne who buys and sells for his own account for short-term profit."

34. *Mirro-Dynamics Corp. v. United States*, 374 F.2d 14 (7th Cir.), *cert. denied*, 389 U.S. 896 (1967).

35. *George E. Warren Co. v. United States*, 53 F. Supp. 578 (D. Mass. 1944).

36. *Treas. Reg. § 1.212-1(g)* (1975) states that:

Fees for services of investment counsel, custodial fees, clerical help, office rent, and similar expenses paid or incurred by a taxpayer in connection with investments held by him are deductible under section 212 only if (1) they are paid or incurred by the taxpayer for the production or collection of income or for the management, conservation, or maintenance of investments held by him for production of income; and (2) they are ordinary and necessary under all the circumstances, having regard to the type of investment and to the relation of the taxpayer to such investment.

Section 22(a)(2), the predecessor of section 212, was added to the Code in 1942 in response

consequence, a trader enjoys deductions comparable to those available to a dealer and the capital asset treatment granted to an investor.

### *Investor*

Investors have been defined as those individuals whose primary concerns in making purchases are regular dividend income, safety of the original investment, and gain through the investment's long-term appreciation in value.<sup>37</sup> These taxpayers may have a long history of purchases and sales, but their transactions are not equivalent to a trade or business.

The investor holds stock and securities as capital assets. Therefore, under section 1234(a)(1) his options on these stocks and securities are also capital assets. Since capital assets are involved, a thorough analysis demands that all transactions be broken down into their component parts: basis, realization event, character of gain or loss, and holding period. When viewed as a totality the complexity of the Code's regulation of options can tie an intellectual Gordian knot. When considered separately, the importance of the individual factors may be perceived and their impact on taxation may be understood. Furthermore, once the complexities of puts, calls, straddles and their interrelationships with short sales and wash sales have been sorted, the more exotic option forms such as butterfly spreads<sup>38</sup> and reverse option hedges<sup>39</sup> become comprehensible. For

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to the Supreme Court's decision in *Higgins v. Commissioner*, 312 U.S. 212 (1941). In *Higgins*, the Court denied deductions to certain investors holding that the activities of these investors did not constitute what the Code defined as a "trade or business." In 1942, Congress stated:

A deduction under this section [22(a)(2)] is subject, except for the requirement of being incurred in connection with a trade or business, to all the restrictions and limitations that apply in the case of the deduction under section 23(a)(1)(A) of an expense paid or incurred in carrying on any trade or business.

H.R. REP. NO. 2333, 77th Cong., 2d Sess. 75; S. REP. NO. 1631, 77th Cong., 2d Sess. 88. Therefore, as the Court later noted in *Whipple v. Commissioner*, 373 U.S. 193, 200 (1962):

§ 23(a) was amended not by disturbing the Court's definition of "trade or business" but by following the pattern that had been established since 1916 of "[enlarging] the category of incomes with reference to which expenses were deductible." *McDonald v. Commissioner*, 323 U.S. 57, 62 (1944).

37. 3b MERTENS, *LAW OF FEDERAL INCOME TAXATION*, § 22.153, at 1085 (1973).

38. Where listed options are involved, a spread is the purchase of one option and the sale of another on the same stock. A back spread has a greater exercise price on the long position than on the short position. A front spread has an exercise price on the long position which is less than or equal to the exercise price on the short position. A butterfly spread combines a front spread and a back spread. The butterfly spread also requires the same expiration date on all of the options and the same exercise price on all of the options which the taxpayer writes. See G. GASTINEAU, *THE STOCK OPTIONS MANUAL* 231-33 (1975).

39. In this hedge, the taxpayer owns more than one call option for each round lot on which he is short. *Id.* at 238.

purposes of federal taxation, these exotica may be broken down and treated as a combination of simpler securities and options transactions.<sup>40</sup>

### SHORT SALES

A short sale is defined as the sale of borrowed property which is eventually "covered by the purchase of new property or by the delivery of long property."<sup>41</sup> When selling short the investor can profit only if the value of the borrowed property falls. This is best illustrated by an example:

You instruct your broker to sell short 100 shares of ABC. Your broker borrows the stock so he can deliver the 100 shares to the buyer. The money value of the shares borrowed is deposited by your broker with the lender. Sooner or later you must cover your short sale by buying the same amount of stock you borrowed for return to the lender. If you are able to buy ABC at a lower price than you sold it for, your profit is the difference between the two prices. . . . But if you have to pay more for the stock than the price you received, that is the amount of your loss. . . .<sup>42</sup>

Formerly, the two major functions of short sales were conversion of short-term paper profit into long-term capital gain,<sup>43</sup> and conversion of long-term capital loss into short-term capital loss.<sup>44</sup> When a taxpayer transformed the character of both his gain and his loss he reduced significantly his tax burden.<sup>45</sup>

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40. Treas. Reg. § 1.1234-2(c) (1972).

41. MERTENS, LAW OF FEDERAL INCOME TAXATION, CODE COMMENTARY, § 1.1233:1, at 42 (1975).

In *Provost v. United States*, 269 U.S. 443, 450-51 (1925), the Court defined a short sale as: a contract for the sale of shares which the seller does not own or the certificates for which are not within his control so as to be available for delivery at the time when, under the rules of the Exchange, delivery must be made.

42. THE NEW YORK STOCK EXCHANGE, THE LANGUAGE OF INVESTING 29 (1974).

43. MERTENS, LAW OF FEDERAL INCOME TAXATION, CODE COMMENTARY, § 1233:1, at 42 (1975).

44. *Id.*

45. Unlike other forms of income, long-term capital gains receive favorable tax treatment under the Code. For example, a taxpayer may deduct from his gross income (including all capital gains) one-half of the excess of his *net* long-term capital gain over his *net* short-term capital loss. Consequently, only the remaining portion of his gain will be subject to the Government's exactions. Treas. Reg. § 1.1202-1. However, except for their impact upon the taxpayer's net short-term loss, short-term capital gains are taxed at the same rate as ordinary income. INT. REV. CODE OF 1954, § 61(a)(3). Under INT. REV. CODE OF 1954, § 1211(b), a noncorporate taxpayer's short-term capital losses are subtracted from his short-term capital gains. Any net short-term capital loss is then used to reduce the taxpayer's net long-term capital gains. Finally, the resultant net loss, if any, may be deducted from ordinary income to the extent of not more than \$1,000.00 per year. The Tax Reform Act of 1976, Pub. L. No. 94-455, § 1401 (Oct. 4, 1976), increases the amount of this deduction to \$2,000.00 for taxable



To change the character of gain in his long position the taxpayer acquired a short position in the same stock.<sup>46</sup> This froze the taxpayer's gain since any loss on the long position would be offset by a profit on the short position. Because his gain was insured against loss, the taxpayer had only to wait until long-term gain would be realized on the stock and then close the short sale. Thus, the taxpayer obtained all the advantages of a long-term asset without assuming any of the risks which usually accompany waiting 6 months and a day. However, the members of Congress felt these transactions had no economic purpose independent of the reduction of tax liability.<sup>47</sup> In enacting section 211 of the Revenue Act of 1950,<sup>48</sup> Congress altered the tax code to foreclose this use of short sales.

The regulation of short sales has been continued by the Internal Revenue Code of 1954. Section 1233 recharacterizes a long-term capital gain as short-term in two situations: where the taxpayer realizes capital gain on a short sale and has held property substantially identical to that sold short for less than 6 months;<sup>49</sup> and where the taxpayer acquires substantially identical property during the period between the opening and the closing of the short sale.<sup>50</sup> This recharacterization eliminates the use of a short sale to freeze gains.

Section 1233 also treats most purchases of puts as short sales.<sup>51</sup> Since a put is a short position on the stock, it too may be used to freeze short-term gain into long-term capital gain.<sup>52</sup> Thus, although a put and a short sale differ in many respects, each can be used to produce the same result. Consequently, it is not surprising that the two transactions receive the same treatment under section 1233.<sup>53</sup>

Freezing short-term capital gains into long-term capital gains is not the only abuse which section 1233 prevents. The section is also

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years beginning in 1977 and to \$3,000.00 for those taxable years beginning after 1977. In addition, the Act provides that for the taxable years beginning in 1977 the holding period for long-term capital gain or loss will be 9 months and for taxable years beginning after December 31, 1977 the holding period will be 1 year.

46. A taxpayer is long on a given stock or security whenever he benefits from a rise in the price of the stock. For example, both the owner of 100 shares of X Corp. and the holder of a call on 100 shares of X Corp. are "long on X" since any increase in the price of those shares will inure to their benefit. Conversely, those taxpayers who benefit from a decline in the price of the stock are short on that stock. For example, both an individual who sells short 100 shares of X Corp. and the holder of a put on 100 shares of X Corp. both hold short positions on X Corp. as any decline in the price will inure to their benefit.

47. H.R. REP. NO. 2319, 81st Cong., 2d Sess. 54-56 (1950).

48. Act of September 23, 1950, ch. 994, § 211, 64 Stat. 933.

49. INT. REV. CODE OF 1954, § 1233(b).

50. *Id.*

51. *Id.*

52. See text accompanying notes 94 and 95 *infra*.

53. H.R. REP. NO. 2319, 81st Cong., 2d Sess. 56 (1950).

designed to forestall the use of short sales to transform long-term capital losses into short-term losses. Formerly, when a short sale was used to freeze gain in securities and the fair market value of those securities continued to rise, the taxpayer could sell his original shares and generate long-term capital gains. Simultaneously, by closing the short sale with a second purchase of the stock he could produce short-term capital loss. While technically legal, these maneuvers had no economic purpose save tax avoidance. Congress enacted section 1233(d) to eliminate the use of this strategy.<sup>54</sup> Section 1233(d) provides that when on the day of the short sale a taxpayer has held substantially identical property for more than 6 months, and when the short sale results in a loss, then such loss is long-term capital loss notwithstanding section 1234.

Comprehension of section 1233 requires an understanding of the term "substantially identical property." The regulations help little since they state that "substantially identical property" has the same meaning as in section 1091,<sup>55</sup> and that the term is flexible and must be fitted to suit the facts and circumstances in each case.<sup>56</sup> Fortunately, both case law and revenue rulings have helped clarify these generalities. *Trenton Cotton Oil v. Commissioner*<sup>57</sup> interpreted the phrase in light of the congressional intent behind section 1091. The court held that "substantially identical property" meant "property materially or essentially the same."<sup>58</sup> In Revenue Ruling 56-406,<sup>59</sup> the Service took the position that "something less than precise correspondence will suffice"<sup>60</sup> to make the assets substantially identical. Generally, the factors which are weighed in determining if one security is substantially identical to another include:<sup>61</sup> earning power, interest rates, underlying assets, security, conditions of retirement, and term or maturity date. Having considered these factors, the Service ruled that in general when calls are written they will not be deemed "substantially identical" to their related common shares.<sup>62</sup> However, convertible bonds,<sup>63</sup> convertible preferred stock<sup>64</sup> and warrants<sup>65</sup> may or may not be substantially identical to

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54. *Id.* at 54-56.

55. Treas. Reg. § 1.1233-1(d)(1) (1967).

56. *Id.*

57. 148 F.2d 208 (6th Cir. 1945) (construing § 118 of the Internal Revenue Code of 1939).

58. *Id.* at 209.

59. 1956-2 CUM. BULL. 523. See also *Hanlin v. Commissioner*, 108 F.2d 429 (5th Cir. 1939).

60. 1956-2 CUM. BULL. 523, 524.

61. Treas. Reg. § 1.1233-1(d)(1) (1967).

62. Rev. Rul. 58-384, 1958-2 CUM. BULL. 410.

63. Treas. Reg. § 1.1233-1(d)(1) (1967).

64. *Id.*

65. Rev. Rul. 56-406, 1956-2 CUM. BULL. 523.

the common stock. These factors should be remembered whenever a taxpayer contemplates the use of a short sale or put in an investment strategy.

The objective of section 1233 is to eliminate two specific abuses. Where the potential for those abuses is not present, section 1233's recharacterization provisions do not apply. There are two situations where that potential is non-existent: where the taxpayer already has held the stock long enough to realize long-term capital gain, and where the taxpayer uses the put to hedge his investment. Each of these will be considered separately.

The gain on a short sale is given long-term capital gains treatment if, on the day of the short sale, either the taxpayer or the taxpayer's spouse<sup>66</sup> has owned for more than 6 months stocks or securities substantially identical to those sold short.<sup>67</sup> Section 1233 also requires that those securities be delivered to close the short sale. They may not be replaced by comparable stocks or securities purchased prior to the date of the short sale. Indeed, when the taxpayer owns one block of stock or securities for longer than 6 months, sells short substantially identical property and then acquires a second block of the stock or securities prior to closing the short sale, any gain realized is characterized as short-term capital gain to the extent of the second block.<sup>68</sup> This is the case regardless of which block is delivered to close the short sale.<sup>69</sup>

The second exception to the general rule is contained in section 1233(c). That section permits the taxpayer to realize long-term capi-

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66. INT. REV. CODE OF 1954, § 1233(e)(2)(C) provides in pertinent part:

[I]n the case of a short sale of property by an individual, the term "taxpayer", in application of this subsection and subsections (b) and (d) shall be read as "taxpayer or his spouse"; but an individual who is legally separated from the taxpayer under a decree of divorce or of separate maintenance shall not be considered as the spouse of the taxpayer.

67. Treas. Reg. § 1.1233-1(c)(6) (1967).

68. Treas. Reg. § 1.1233-1(c)(6), example (3) (1967) gives the following illustration: A buys 100 shares of X stock at \$10 per share on February 1, 1955, sells short 100 shares of X stock at \$16 per share on September 1, 1955, sells on October 1, 1955, at \$18 per share the 100 shares of X stock purchased on February 1, 1955, and closes the short sale on October 1, 1955 with 100 shares of X stock purchased on that date at \$18 per share. The \$800 gain realized upon the sale of the 100 shares of X stock purchased on February 1, 1955, is a long-term capital gain to which section 1233 has no application. Since A had held 100 shares of X stock on the date of the short sale for more than 6 months, the \$200 loss sustained upon the closing of the short sale is, by application of rule (3) in subparagraph (2) of this paragraph, a long-term capital loss. If, instead of purchasing 100 shares of X stock on October 1, 1955, A closed the short sale with the 100 shares of stock purchased on February 1, 1955, the \$600 gain realized on the closing of the short sale would be a long-term capital gain to which section 1233(b) has no application.

69. *Id.*

tal gain on puts used to hedge against loss. It requires the taxpayer to acquire the put and the underlying property on the same day, and to identify the underlying property as being intended to exercise the put. By carving out this exception, section 1233(c) achieves a more equitable result than its predecessor, section 117(l)(1) of the 1939 Code.<sup>70</sup> Section 1233(c), unlike section 117(l)(1), allows the taxpayer to establish a hedge against loss without exacting a short-term gain in return. Thus, a taxpayer is permitted to limit his losses by exercising the put and delivering the stock or securities at the agreed price. Since the put must be purchased on the same day as the underlying property and must be identified with that property, freezing short-term capital gain into long-term capital gain is an impossibility. Furthermore, if the put is not exercised, its cost is added to the basis of the identified property. In either event, since the abuses which section 1233 was designed to eliminate are not present, there is no reason to prevent an individual from enjoying long-term capital gains treatment.

#### WASH SALES

A wash sale is a transaction designed to generate a loss while permitting the taxpayer to maintain an investment position.<sup>71</sup> For example, suppose an investor buys 100 shares of X corporation at \$10.00 a share and the stock declines in price to \$1.00 a share. Suppose further that the taxpayer is basically optimistic about the stock's long-term prospects but wishes to generate capital losses in order to offset capital gains. Were it not for section 1091,<sup>72</sup> the taxpayer could sell his 100 shares, generate \$900.00 of loss and then repurchase the shares at \$1.00 per share in order to maintain his investment position.

Section 1091(a) disallows a deduction for any losses sustained by the taxpayer arising out of any sale or other disposition of stock or securities during the period running from 30 days before to 30 days after the taxpayer acquires<sup>73</sup> or enters into a contract to acquire

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70. Act of September 23, 1950, ch. 994, § 211, 64 Stat. 933.

71. INT. REV. CODE OF 1954, § 1091(a). For a classic example of such manipulation see Samuel M. Vauclain, 16 B.T.A. 1005 (1929).

72. The 1919 Act contained no provisions to prevent this from occurring and perceptive taxpayers quickly realized the tax avoidance possibilities of that omission. Congress plugged the hole in 1921 by enacting into law § 1091's predecessor, § 214(a)(5). Act of Nov. 23, 1921, ch. 136, § 214(a)(5), 42 Stat. 239-40.

73. The term "acquire" has broader meaning than "buy." It also encompasses the receipt of stock by gift and inheritance, *Morris v. Commissioner*, 38 B.T.A. 265(A) (1938). Further, the date of delivery is irrelevant. The date of acquisition alone determines whether the stock is governed by § 1091. Rev. Rul. 59-418, 1959-2 CUM. BULL. 184.

substantially identical stock or securities. The wash sale provisions do not foreclose the deduction of the loss; they merely forestall its recognition as section 1091(d) readjusts the basis of the property involved.<sup>74</sup>

By its very nature, an option may often be considered substantially identical to the related stock. Thus, whenever a taxpayer has sold a stock or security at a loss, buying a related option to purchase may trigger a wash sale. Therefore, three transactions which are both frequent and illustrative will be considered in connection with the wash sale provisions of section 1091: the sale of stock at a loss, the sale of a convertible bond at a loss, and the sale of convertible preferred stock at a loss.

When a taxpayer sells stock at a loss and then purchases a call option on that stock a wash sale results.<sup>75</sup> However, writing a call in either an opening or a closing transaction does not produce a wash sale.<sup>76</sup> In Revenue Ruling 58-384,<sup>77</sup> the Service announced that when calls are written they are not substantially identical to the shares subject to them. Since the options and the shares are not substantially identical, they cannot generate a wash sale.<sup>78</sup>

The sale of a convertible bond at a loss creates the potential for a wash sale. As yet it is unclear whether the purchase of an option to

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74. Treas. Reg. § 1.1091-1(h), example (2) (1967) gives the following illustration:

A, whose taxable year is the calendar year, on September 21, 1954, purchased 100 shares of the common stock of the M Company for \$5,000. On December 21, 1954, he purchased 50 shares of substantially identical stock for \$2,750, and on December 27, 1954, he purchased 25 additional shares of such stock for \$1,125. On January 3, 1955, he sold for \$4,000 the 100 shares purchased on September 21, 1954. There is an indicated loss of \$1,000 on the sale of the 100 shares. Since, within the 61-day period, A purchased 75 shares of substantially identical stock, the loss on the sale of 75 of the shares (\$3,750 - \$3,000, or \$750) is not allowable as a deduction because of the provisions of section 1091. The loss on the sale of the remaining 25 shares (\$1,250 - \$1,000, or \$250) is deductible subject to the limitations of sections 267 and 1221. The basis of the 50 shares purchased December 21, 1954, the acquisition of which resulted in the nondeductibility of the loss (\$500) sustained on 50 of the 100 shares sold on January 3, 1955, is \$2,500 (the cost of 50 of the shares sold on January 3, 1955) + \$750 (the difference between the purchase price \$2,750) of the 50 shares acquired on December 21, 1954, the selling price (\$2,000) of 50 of the shares sold on January 3, 1955, or \$3,250. Similarly, the basis of the 25 shares purchased on December 27, 1954, the acquisition of which resulted in the non-deductibility of the loss (\$250) sustained on 25 of the shares sold on January 3, 1955, is \$1,250 + \$125, or \$1,375.

75. *Dyer v. Commissioner*, 74 F.2d 685 (2d Cir.), cert. denied, 296 U.S. 586 (1935).

76. See text accompanying notes 117 and 118 *infra*.

77. 1958-2 CUM. BULL. 410.

78. Furthermore, remembering that writing a call obligates the writer to sell additional shares at the time of the option's exercise, there is no need to apply the wash sale rules since an investment position cannot be preserved.

buy in an opening or closing transaction<sup>79</sup> causes a wash sale. It appears that if the option's underlying stock is sufficiently similar to the convertible bond to be deemed substantially identical, then buying a call might create a wash sale. Two factors lead to this conclusion: first, the taxpayer has the burden of establishing that substantially identical property has not been purchased;<sup>80</sup> second, loss is disallowed to the taxpayer if repurchase occurred within the 2 month period even though delivery is postponed.<sup>81</sup> Similarly, should common or convertible preferred shares be acquired, the potential for a wash sale is present. Whether a wash sale results depends, as always, on the similarity of the salient economic characteristics of the convertible security sold and the common or convertible shares purchased. Writing a call does not pose all of these problems. The Service has ruled that these opening and closing transactions are not substantially identical to the underlying stock.<sup>82</sup>

The wash sale restrictions on selling a convertible preferred share of stock at a loss are not well defined. While neither writing a call nor selling a put in an opening or closing transaction generates a wash sale, it cannot be resolved whether the purchase of common shares or convertible securities has such a result. Revenue Ruling 56-406<sup>83</sup> states that:

where the preferred stock or bonds are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may be such as to make such bonds or preferred stock and the common stock substantially identical property.<sup>84</sup>

This revenue ruling indicates that two classes of shares and securities may sufficiently resemble one another to be deemed substantially identical property. The ruling also gives the factors relevant to the determination. However, it would appear that the only sure way to avoid a wash sale when convertible securities have been sold at a loss is to avoid purchasing comparable stock or securities during the 60-day period set forth in section 1091(a).

Finally, it should be noted that the wash sale provisions of section

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79. The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2136 (Oct. 4, 1976) amends § 1234 and defines a closing transaction as: any termination of the taxpayer's obligation under an option in property other than through the exercise or lapse of the option.

80. *Mellon v. Commissioner*, 36 B.T.A. 977 (1937).

81. Rev. Rul. 59-418, 1959-2 CUM. BULL. 184.

82. Rev. Rul. 58-384, 1958-2 CUM. BULL. 410.

83. 1956-2 CUM. BULL. 523.

84. *Id.* at 524-25 (emphasis omitted).

1091 do not disallow loss in those transactions typically important to an options investor. Neither the loss sustained covering a short sale<sup>85</sup> nor the loss generated by writing a call in a closing transaction<sup>86</sup> creates the potential for a wash sale. However, the central considerations for any taxpayer whose actions might be governed by section 1091 remain: have stocks or securities been sold at a loss; have substantially identical properties been purchased; have such properties been purchased within the period beginning 30 days before the date of the sale or disposition and ending 30 days afterwards;<sup>87</sup> and does the taxpayer care whether his loss is disallowed. Upon consideration of these factors, the taxpayer should decide whether section 1091 poses a problem to his investment plans.<sup>88</sup>

### SIMPLE OPTIONS TRANSACTIONS<sup>89</sup>

The obvious starting point for the consideration of options is at

85. Cf. Treas. Reg. § 1.1091-1(g) (1967), so long as the taxpayer is not short-against-the-box.

86. Rev. Rul. 58-384, 1958-2 CUM. BULL. 410.

87. INT. REV. CODE OF 1954, § 1091(a).

88. For a more detailed examination of wash sales see Brach, *Wash Sales and Short Sales*, N.Y.U. 27TH INST. ON FED. TAX. 1167 (1969) and Dixon, *Wash Sales and Short Sales*, N.Y.U. 18TH INST. ON FED. TAX. 335 (1960).

89. On October 4, 1976, President Ford signed the Tax Reform Act of 1976 into law. For the purposes of this article, the Act modifies section 1234 in two respects. First, the amended section provides that those holders of options whose transactions are not governed by section 1233(b) would receive capital asset treatment on the sale or lapse of the option. Second, the new provisions give writers of options short-term capital asset treatment for the closing or expiration of their options. These modifications would reverse the private rulings of September 7, 1973 and of April 8, 1974 which provide, *inter alia*, that ordinary income is generated in these situations. By reversing these private rulings, the bill would close a tax loophole. H.R. REP. No. 1192, 94th Cong., 2d Sess. 2 (1976) gives the following example of the use of such a loophole:

Assume . . . that a taxpayer in the 50 percent tax bracket purchases 100 shares of IBM for \$200 a share; he also writes a call on the stock at a striking price of \$200 per share, for a premium of \$2,500. If the value of the stock rises to \$250 per share, and the taxpayer has held this stock for more than 6 months, he may sell the stock, realizing a long-term capital gain of \$5,000 on which he owes \$1,250 tax. He also enters a closing transaction with respect to his call by purchasing a call on IBM at a striking price of \$200 per share; he would pay a premium of about \$5,000 under these circumstances, and the resulting loss of \$2,500 (determined by subtracting the premium the taxpayer received for the call he wrote from the premium he paid for the call he purchased) would be ordinary loss which could be offset against ordinary income for a tax savings of \$1,250. The net result is that the taxpayer pays no tax on the transactions producing a net economic income of \$2,500.

A comparable set of circumstances permitted the taxpayer to convert ordinary income into capital gain:

[A]ssume that a taxpayer in the 50 percent tax bracket purchases 100 shares of IBM for \$200 a share; he also writes a call on the stock at a striking price of \$200 per share, for a premium of \$2,500. If the value of the stock rises to \$250 per share, and the taxpayer has held his stock for more than 6 months, he may sell the stock,

their creation. As noted earlier, an option is a contract.<sup>90</sup> The consideration paid by the buyer of the option is termed a premium. However, the fact that a premium has been paid or received is devoid of any immediate tax consequences. No essential changes have been made concerning the ownership, possession, form or location of the underlying asset. Basically, an option is the right to make such changes in the future. Since *A. E. Hollingsworth*,<sup>91</sup> no federal tax consequences have arisen from the granting of an option to buy and the receipt of a premium. This principle has been applied both to the writers and to the holders of options by Revenue Ruling 58-234.<sup>92</sup> The realization event is not deemed to occur until the option terminates by exercise, lapse or sale.<sup>93</sup> While these three events are important, their impact can be understood only in the context of the transaction of which they are a part.

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realizing a long-term capital gain of \$5,000 on which he owes \$1,250 tax. He also enters a closing transaction with respect to his call by purchasing a call on IBM at a striking price of \$200 per share; he would pay a premium of about \$5,000 under these circumstances, and, under present law, the resulting loss of \$2,500 (determined by subtracting the premium the taxpayer received for the call he wrote from the premium he paid for the call he purchased) would be ordinary loss which could be offset against ordinary income for a tax saving of \$1,250. The net result, under the present law, is that the taxpayer pays no tax on the transactions producing a net economic income of \$2,500.

Under the committee bill, the \$2,500 loss on the closing transaction would be treated as a short term capital loss which would have to be netted against the taxpayer's capital gains. Thus, if the transactions described above were the taxpayer's only capital transaction [sic] for the year, the \$2,500 short term capital loss would be subtracted from the \$5,000 long term capital gain, leaving a net long term capital gain of \$2,500. A taxpayer in the 50 percent bracket would pay a tax of \$625 on this amount.

*Id.* at 9. However, these modifications also removed an unduly heavy tax-burden from the shoulders of some taxpayers.

Under present law, a person who has substantial capital losses may not offset those losses (except to a very limited extent) against premium income, even if the capital losses result from transactions in stock underlying covered options. Thus, for example, assume that X purchases 1,000 shares of IBM at \$200 per share and writes a call on the stock at that price, receiving a premium of \$10,000. If the stock declines to 190, the call will lapse (because it is worthless) and, under present law, X will have ordinary income of \$10,000. If he sells the IBM stock, he will also have a \$10,000 capital loss but, under present law, only \$1,000 of this amount could be offset against the income from writing the call.

The committee bill deals with this problem by providing that income from a lapsed option is to be treated as short term capital gain. Thus, in the example set forth above, the \$10,000 gain from writing the option could be offset against the \$10,000 capital loss which the taxpayer experienced with respect to the sale of the stock.

*Id.*

90. See text accompanying notes 7 and 8 *supra*.

91. 27 B.T.A. 621 (1933), *acquiesced in* CUM. BULL. xii-i, 7.

92. 1958-1 CUM. BULL. 279, *clarified*, Rev. Rul. 68-151, 1968-1 CUM. BULL. 363.

93. *Id.*



An investor can either write or hold a put, call or straddle. Each of these involves the taxpayer in a different mesh of Code sections, revenue rulings, and decisional law. Before the tax-planning aspects of options are discussed, their simplest tax consequences will be outlined.

### *Holding a Put*

When a taxpayer holds a put, he has the contractual right to sell stock to the writer of the put at an agreed price.<sup>94</sup> In exchange for this right, he pays a premium. The typical investor will decide to hold a put when he also owns stock and fears that its price may fall. By purchasing the put, the taxpayer is guaranteed a buyer for this stock at an acceptable price. Should the stock's price remain stable or increase, the taxpayer can simply let the put expire. Due to section 1233's short sale provisions, the holder of a put must be considered at four different times: when he buys the put having owned substantially identical stock for less than 6 months and a day; when he buys the put and then purchases substantially identical stock; when he buys stock on the same day as the put and identifies the stock purchase with the put; and finally, either when substantially identical stock has been held for over 6 months or when no such stock is owned while the taxpayer holds the put. Further, when analyzing these situations the three realization events, exercise, lapse, and sale, must also be considered since the Code treats each differently.

When the taxpayer buys a put while having owned substantially identical stock for less than 6 months and a day, the character of his gain on the option depends upon how that gain is realized. The sale of a put is governed by section 1234(a)(1).<sup>95</sup> Therefore, the taxpayer will realize long-term capital gains on the put provided that he holds the put for at least 6 months and a day prior to selling it. If the put is sold, the related stock is unaffected. For example, the stock's holding period begins on the day of its acquisition and not the put's sale.<sup>96</sup> Consequently, long-term capital gains may also be realized on the stock's sale. However, unlike the sale of a put, both the exercise and the lapse of the option are governed by section 1233. As a result, in these two situations a taxpayer affects his related stock by holding a put and vice versa. Under Revenue Ruling 71-

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94. Rev. Rul. 58-234, 1958-1 CUM. BULL. 279, 283.

95. Special Ruling, Sept. 7, 1973, 749 CCH 1974 STAND. FED. TAX. REP. ¶ 6596. See also Rev. Rul. 71-521, 1971-2 CUM. BULL. 313.

96. Special Ruling, Sept. 7, 1973, 749 CCH 1974 STAND. FED. TAX. REP. 6596.

521,<sup>97</sup> when such a put is exercised the premium paid to the taxpayer offsets the price received by him for his stock in determining gain. The holding period of the stock begins on the day that the put is exercised. Should the put lapse, its premium receives capital loss treatment<sup>98</sup> and the length of time that the put was held is the sole consideration in the determination of whether that capital loss is long or short-term. However, the holding period of the stock is altered.<sup>99</sup> It does not become a long-term capital asset until an additional 6 months and a day elapse from the day of the put's expiration.<sup>100</sup>

When a taxpayer buys a put and subsequently buys substantially identical stock, once again the character of the gain realized on the put depends upon the realization event.<sup>101</sup> A sale is governed by section 1234. Therefore, the sale of a put results in capital gains or losses which are long or short-term depending upon how long the put has been held.<sup>102</sup> The holding period of the underlying stock is unaffected by the sale of the put. Should the put lapse, its cost is treated as being either a long or a short-term loss depending upon the holding period of the option.<sup>103</sup> Additionally, if the put is exercised, its cost is deducted from the sale proceeds of the stock.<sup>104</sup> The primary distinction between this situation and the aforementioned situation is the treatment of the related stock. Due to the short sale provisions of section 1233, when the put either expires or is exercised only short-term gain is produced regardless of how long the related stock has been owned.

As noted earlier,<sup>105</sup> the short sale provisions of section 1233 do not apply where the taxpayer purchases both the stock and the put on the same day and identifies the put as intended to hedge on the stock position.<sup>106</sup> Section 1233(c) carves out this exception to the

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97. 1971-2 CUM. BULL. 313.

98. *Id.* at 314. This ruling notes that INT. REV. CODE OF 1954, § 1234(b) treats the expiration of a put as if it was the sale or exchange of a capital asset. Therefore, under § 1221 of the Code, the holding period of the put prior to expiration will determine whether the loss is long or short-term. Under the new section 1234(b)(2) this continues to be the case.

99. The acquisition of a put is treated by § 1233(b) as if it was a short sale. Further, the expiration or exercise (but not the sale) of a put is treated as the closing of a short sale. Therefore, in this situation the holding period of the stock begins to run on the earliest of three possible occasions: the day the related stock is sold, the day the put is exercised, or the day the put lapses.

100. INT. REV. CODE OF 1954, § 1233(b).

101. See text accompanying notes 95 through 100 *supra*.

102. *Id.*

103. Rev. Rul. 71-521, 1971-2 CUM. BULL. 313, 314.

104. *Id.* at 313.

105. See text accompanying notes 69 through 71 *supra*.

106. Rev. Rul. 58-234, 1958-1 CUM. BULL. 279.

general rule in order to allow the taxpayer to hedge his investments. Of course, if the put is sold, there has not been a true hedge. In this instance, the section 1233(c) "exception" is inapplicable.<sup>107</sup> These options are governed by section 1234; both the put and its related stock are treated as ordinary capital assets subject to the standard holding period requirements. Under the section 1234 provisions, as interpreted by Revenue Ruling 58-234,<sup>108</sup> if the identified stock is delivered to close the sale, then the premium paid for the put reduces the amount realized when determining gain.<sup>109</sup> Similarly, when the put is allowed to expire, the cost of the put is added to the stock half of the hedge. Because of this association between the options and the stock, neither gain nor loss is realized until the stock is sold. Except for the alteration of its basis, the stock is left essentially untouched. For example, its holding period is unaffected by the expiration of the put.

Finally, if the taxpayer never owns related stock during the term of the put, the put is treated as any other capital asset. Similarly, if the put is acquired after the related stock has been held for over 6 months, then the two assets are treated as being wholly separate and distinct.

#### *Holding a Call*

The holder of a call has a contractual right to buy stock at an agreed price from the writer of the call. In exchange for this right, he pays a premium to the writer of the call. An investor usually will hold a call when he thinks that there is a good possibility that the stock's price will rise. By acquiring the right to buy stock at or near its current fair market value, the taxpayer insures that he will benefit from any future appreciation in the value of the stock. If the stock's price does go up, the taxpayer can either exercise his call or sell the call to someone else. Of course, if the stock's price does not rise or if it does not rise enough to compensate for the premium that the taxpayer paid, he can simply let the call expire. No tax consequences attach to the payment of the premium until a realization event occurs.<sup>110</sup> Unlike the holder of a put, the holder of a call need not be concerned about the effect of the option on any related stock which he may own. In Revenue Ruling 58-384,<sup>111</sup> the Service ruled that these options are not substantially identical to their related

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107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.*

111. 1958-2 CUM. BULL. 410.

stock. Therefore, holding a call presents no danger of running afoul of either the wash sale or short sale provisions of the Code. Further, Revenue Ruling 58-234<sup>112</sup> allows the taxpayer to avoid a long-term capital loss by exercising the call instead of selling it. When the call is exercised its cost is added to the basis of the stock acquired. Thus, realization does not occur until the stock is sold. Since the holding period of the acquired stock does not begin until the call is exercised,<sup>113</sup> a short-term loss can be generated by immediately selling the stock. This does not alter the character of the gain because expiration of a call is given sale or exchange treatment under section 1234(a)(1). Therefore, capital gains or losses will be generated in any event.

### *Writing a Put*

The writer of a put has a contractual duty to buy the stock of the holder of the put. In return for assuming this obligation, the writer receives a premium from the holder. The Service has ruled that the receipt of a premium is devoid of any tax consequences until a subsequent realization event occurs.<sup>114</sup> Generally, a taxpayer will write a put when he believes that the stock's price will remain steady or rise. If the taxpayer is correct, it is unlikely that the holder of the put will exercise the option since such a holder could simply sell his stock on the exchange and make more money. In this event, the writer will still benefit from the premium which he was paid. Of course, if the taxpayer is wrong and the stock's price drops, he will probably have to buy the shares since the option's striking price is the best price that the holder of the put can get.

Unlike his holding a put, when a taxpayer writes a put, he cannot cause a short sale. Section 1233(b) is unambiguous in this regard. It states that its application is limited to "the acquisition of an option to sell property." Thus, when writing a put one need not be concerned about related stock insofar as short sales are concerned.

Until the Tax Reform Act of 1976, the expiration of a put produced ordinary income,<sup>115</sup> because neither a sale nor an exchange had occurred.<sup>116</sup> Therefore, despite the put's character as a capital asset, only ordinary income was derived. The same reasoning applied to the closing of a put. Repurchase was not considered a sale

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112. 1958-1 CUM. BULL. 279, 283.

113. E. T. Weir, 10 T.C. 996 (1948).

114. For calls see Rev. Rul. 58-234, 1958-1 CUM. BULL. 279, 283 and for puts see Rev. Rul. 71-521, 1971-2 CUM. BULL. 313.

115. Rev. Rul. 58-234, 1958-1 CUM. BULL. 279, 284.

116. Special Ruling, April 8, 1974, 749 CCH 1974 STAND. FED. TAX. REP. ¶ 6597.

or exchange. The ordinary income produced on the day of the repurchase was equal to the difference between the amount paid by the writer to close the option and the premium paid to open it. Section 1234(b)(1) now characterizes all such gains as short-term gains. The new provisions of section 1234 characterize a "closing transaction" as a "sale or exchange."<sup>117</sup>

### *Writing a Call*

The writer of a call has a contractual duty to sell stock to the holder of a call. In return for assuming this obligation, the writer of a call receives a premium from the holder of the call. This investment technique is effective where one expects the price of the stock to remain relatively stable or to fall within the next few months. If the price of the stock drops below the striking price, the call probably will not be exercised. The holder could purchase the stock more cheaply on the open market. If the stock moves upward, beyond the striking price plus the premium, the call probably will be exercised since the striking price is the best price available for the stock.

Formerly, the writing of exchange calls was governed by two private rulings issued by the Service on September 7, 1973 and April 8, 1974.<sup>118</sup> These rulings provided that the lapse of a call produced ordinary income<sup>119</sup> while leaving the underlying stock unaffected.<sup>120</sup> The Tax Reform Act of 1976 reverses these rulings.<sup>120.1</sup> Of course, this does not alter the fact that when the call is exercised its writer must sell the underlying stock. Both the gain realized on the sale and the calculation of the holding period of the stock reflect the transaction's origin in an option. To determine the gain or loss realized, the writer adds the premium to the proceeds of the sale.<sup>121</sup> The holding period of the stock extends from the day it was purchased to the day that the call was exercised.<sup>122</sup> Until the enactment of the Tax Reform Act, these factors provided the taxpayer with a method for slightly reducing his taxes. When the underlying stock was substantially above the exercise price of the call, the writer could repurchase the call and close the transaction rather than wait for the call to be exercised. This was advantageous to the investor because re-

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117. See note 79 *supra*.

118. Special Ruling, Sept. 7, 1973, 749 CCH 1974 STAND. FED. TAX. REP. ¶ 6596; Special Ruling, April 8, 1974, 749 CCH 1974 STAND. FED. TAX. REP. ¶ 6597.

119. Treas. Reg. § 1.1234-1(b) (1967).

120. See text accompanying notes 110 through 112 *supra*.

120.1 H.R. REP. NO. 1192, 94th Cong., 2d Sess. 3 (1976).

121. Rev. Rul. 58-234, 1958-1 CUM. BULL. 279, 285.

122. Because this situation is governed by § 1234, the holding period of the underlying stock is unaltered.

purchase of an option in a closing transaction generated ordinary loss while the exercise of a call reduced the taxpayer's capital gain. Section 1234(b)(1) terminated the efficacy of this device by providing that such closing transactions produced short-term capital gains and losses.<sup>123</sup>

### *Straddles*

The last major option is the straddle. Prior to its recent modification, the Code defined a straddle as:

a simultaneously granted combination of an option to buy and an option to sell, the same quantity of a security at the same price during the same period of time.<sup>124</sup>

Writing a straddle is tantamount to writing a put and a call simultaneously. The taxpayer who assumes these twin obligations believes that the price of the underlying stock will fluctuate dramatically during the term of the options, but has no idea as to whether that movement will be up or down. So long as the stock moves in only one direction, the taxpayer will be required to perform on only one of the two options and can pocket the premium from the other. Prior to the Tax Reform Act, the Service recognized two basic methods of determining the amount of the total premium attributable to each side of the straddle. The regulations permitted the taxpayer to allocate the premium according to the relative fair market values of the two options.<sup>125</sup> Alternatively, the taxpayer may mechanically distribute the total premium he received attributing 45 percent of it to the put and 55 percent to the call.<sup>126</sup> While Congress has eliminated all references to straddles in section 1234, it would appear

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123. This reduction occurred because the repurchase of a call did not constitute a sale or exchange. For this reason, in Rev. Rul. 70-205, 1970-1 CUM. BULL. 174, the Service ruled that the price paid by a taxpayer to repurchase a call was a capital expenditure. The new section 1234(b)(1) provides that in this situation short-term capital gains or loss are generated by the lapse or closing of such options.

124. Act of Nov. 13, 1966, Pub. L. No. 89-809, § 210, 80 Stat. 1580.

125. Treas. Reg. § 1.1234-2(d) (1971).

126. Rev. Rul. 65-29, 1965-2 CUM. BULL. 1023. See also Rev. Proc. 65-31, 1965-2 CUM. BULL. 1023. Treas. Reg. § 1.1234-2(f), example (1) (1972) illustrates this allocation:

On February 1, 1971, taxpayer A, who files his income tax returns on a calendar year basis, issues a straddle for 100 shares of X corporation stock and receives a premium of \$1,000. The options comprising the straddle were to expire on August 10, 1971. A has allocated \$450 (45 percent of \$1,000) of the premium to the put and \$550 (55 percent of \$1,000) to the call. On March 1, 1971, B, the holder of the put, exercises his option. C, the holder of the call, fails to exercise his options prior to its expiration. As a result of C's failure to exercise his option, A realizes a short-term capital gain of \$550 (that part of the premium allocated to the call) on August 10, 1971.

that either method of allocation may still be used at least until puts are traded on the options exchanges.

A straddle involves two options. Therefore, four distinct situations can arise: a side of a straddle can be exercised, a side can expire, both sides can expire, and a side can be repurchased. The Code treats each of these situations differently.

When a side of a straddle is exercised, the length of time that it has been held is irrelevant since no gain or loss is realized. Instead, the holder of the option increases the basis of his stock by the amount of the premium paid to the writer. The writer treats the exercise in a comparable fashion. When the call side of the straddle is exercised, the regulations require the premium to be added to the amount realized on the sale.<sup>127</sup> Similarly, when the put side is exercised, the premium reduces the basis in the taxpayer's newly acquired stock.<sup>128</sup> No logical reason exists for assuming that such will not continue to be the case.

The characteristic which distinguished straddles from other forms of options was the tax treatment of their expiration. Under the old provisions of section 1234, when any of the other options previously discussed lapsed, the writer received ordinary income. Under section 1234(c), when a side of a straddle expired gain was characterized as short-term capital gain. This was true regardless of how long the taxpayer held the straddle.<sup>129</sup> Furthermore, according to the regulations, the taxpayer still received short-term gains treatment even if both sides of the straddle expired.<sup>130</sup> This was true despite the fact that section 1234(c) spoke in terms of the lapse of an option (singular) and not options (plural).

The lapse of a side of a straddle must be contrasted with its repurchase. By incorporating exchange options into his straddles, an investor can gain liquidity. Thus, he can close a side of his straddle. However, the repurchase produced ordinary income and not capital gains or losses because neither section 1221's sale or exchange requirement nor section 1234(c)'s lapse requirement had been met. This distinction has been eliminated by the new "closing transaction" provision contained in section 1234(b)(1).

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127. Treas. Reg. § 1.1234-2(a) (1972).

128. See note 120 *supra*.

129. Act of November 13, 1966, Pub. L. No. 89-809, § 210, 80 Stat. 1580.

130. Treas. Reg. § 1.1234-2(f) example (3) (1972) illustrates (assuming the same facts as in note 126 *supra*):

except that both B and C fail to exercise their respective options. As a result of the failure of B and C to exercise their options, A realizes short-term capital gains of \$1,000 (the premium for granting the straddle) on August 10, 1971.

## TAX PLANNING AND THE USE OF OPTIONS

Whenever a taxpayer is dealing in a market as volatile as a stock exchange, a major objective is maximization of profit with minimization of risk. The other major objective is favorable tax treatment. While no one can assure profits in either the stock or the options markets, it is possible to use certain countervailing investments to establish a position of limited risk and to reduce taxation to its bare minimum.

*Short-term Paper Profit on a Long Position in Stock*

When a taxpayer has large short-term paper profits in a stock, he has five basic alternatives: holding the stock, selling the stock, deferring recognition but not realization, using the neutral option hedge, and hedging by use of a put. The taxpayer's financial requirements and analysis of current market trends will dictate which of the five routes is taken.

Clearly, the two simplest routes are standing pat and selling. The taxpayer can simply wait for 6 months and a day to elapse and realize long-term capital gain provided he feels that the stock's price accurately reflects its value or that the stock's price will continue to rise. Conversely, if the taxpayer believes that the stock's high price is temporary, the wisest course of action is to sell the stock and take short-term capital gains.

Some owners of highly appreciated stock are more concerned with the timing of recognition than with the character of the capital gain. For example, when a taxpayer is in an unusually high tax bracket in a given year, deferring recognition on the gain until the next year may reduce taxes. A short sale can assist this investor. Selling the stock short-against-the-box<sup>131</sup> defers the tax on the profits while protecting the investor from further market fluctuations by freezing his profits at their current level. It is true that the short sale will interrupt the asset's holding period and thus foreclose the possibility of a long-term capital gain. But as it defers the realization event until a year in which the taxpayer will be in a lower tax bracket, the short sale still can result in substantial tax savings.

The fourth possibility for the owner of highly appreciated stock to consider is the neutral option hedge. A neutral option hedge is a long position in a stock with enough short positions in its related options to counterbalance price variations.<sup>132</sup> This hedge is estab-

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131. Being short-against-the-box occurs when the short seller also is long on the stock but does not use that long position for delivery to the buyer of the stock.

132. See text accompanying notes 11 and 12 *supra*.



lished by writing calls. The premium received by the taxpayer for these calls protects him from losses due to a decline in the price of the stock. If the stock's price declines, the options will not be exercised. If the options are not exercised, the taxpayer will realize short-term capital gain on the premiums.<sup>133</sup> Thus, his loss on the stock is offset to the extent of the gains realized on the options. Of course, if the stock continues to rise and the taxpayer does not close the calls by repurchase, they may be exercised by the holder. Exercise would result in the taxpayer realizing short-term capital gain on the stock. Should this occur, the taxpayer has still minimized investment risk while generating capital gains, albeit short-term gains. If the calls are not exercised, once the stock has been held 6 months and a day, the taxpayer can close the neutral option hedge by purchasing the options, producing short-term gain or loss. While these transactions add commission costs which would not be present if the options lapse, the investor immediately benefits from any appreciation in the stock's price.

The fifth and final method protects the taxpayer's position in the stock by use of a put. By purchasing a put the taxpayer establishes a short position hedging his long position. The short sale provisions of section 1233(b)(1) do not cause a problem for the taxpayer. Under section 1233(b)(1), only the exercise or lapse of a put is treated as a short sale. The sale of a put is regulated by section 1234(a) permitting the taxpayer to realize long-term capital gains. The major difficulty in using puts as a hedge is that they currently are not readily marketable.<sup>134</sup> Therefore, the taxpayer may be unable to sell his put to close the hedge. It does not appear that this method of freezing profit into long-term capital gain will become popular until the options exchanges are allowed to trade puts and thereby afford the investor a liquid market for these options.

#### *Short-term Capital Loss*

When an investor owns stock whose price has dropped precipitously, he may wish to realize short-term capital loss, maintain an investment position, and avoid the wash sale provisions of section 1091 simultaneously. Three alternative strategies are available to achieve these goals: neutral option hedges, buying calls, and buying deep-in-the-money puts.<sup>135</sup> The strategy chosen depends upon the

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133. INT. REV. CODE OF 1954, § 1234(b)(1).

134. See text accompanying notes 6 and 7 *supra*.

135. A deep-in-the-money put is a put with a high striking price in relation to the current fair market value of the stock.

taxpayer's analysis of the stock's near term prospects and the ability of the taxpayer to commit additional equity to the venture.

The neutral option hedge insulates the investor from moderate fluctuations in the stock's price. The appeal of this alternative depends upon the presence of two factors: the taxpayer's belief that the stock is a good long-term investment, and his belief that the stock's price will remain stable during the next few months. If these two factors are present, the investor should proceed with the three stages of neutral option hedging. First, he should establish an option hedge at least 61 days from the end of the stock's short-term holding period by purchasing a second block of stock and writing calls. Then, within 31 days, the taxpayer must sell the stock half of this hedge and designate the sale to be against the second block of stock. At this point, the taxpayer has both his original block and the calls written when the hedge was established. Finally, the hedge is terminated after yet another 31 days when the calls are closed with a purchase. Due to the timing of these transactions, the neutral option hedge permits the taxpayer to avoid section 1091's restrictions on the deduction of loss and to retain his ownership of the stock.

Although the properties of the neutral hedge are marvelous in the abstract, they are premised upon the investor's ability to predict accurately whether the stock's price will remain within a rather narrow range. Should the taxpayer's prognosis be wrong and the stock's price rise sharply, the options will be unprofitable and corrective measures must be taken. At this point, while the taxpayer will have made a handsome paper profit on the stock in the hedge, the losses on the calls will be larger. Assuming that worse has come to worst and time is short while losses are large, the investor should close out these calls and write new calls for 6 months later. Closing the unprofitable calls produces short-term loss. When the second batch is closed, capital gain will be generated.<sup>136</sup> Ultimately, if the stock's lowered price remains stable, long-term capital gain will be realized when the stock is sold. The result of these maneuvers should drop the taxpayer into a small pool of black ink.

If the conditions precedent to the use of a neutral option hedge are absent, buying calls may also be utilized to gain short-term capital loss while retaining an investment position. Buying calls is desirable in two circumstances: when the taxpayer believes that the stock will recover and/or when he is unwilling or unable to use an option hedge. This method requires three simple steps. First, the taxpayer buys call options at a time not less than 61 days from the

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136. INT. REV. CODE OF 1954, § 1234(b)(1).

end of the short-term holding period of the stock. Second, 31 days later, the taxpayer sells his original shares realizing a short-term capital loss. Note that at this point even if the stock's price rises the taxpayer will be protected since he still owns calls on the stock. Third, after an additional 31 days the taxpayer buys replacement shares and lets his calls expire. This last step is taken instead of exercising the calls since the expiration of calls produces additional short-term capital loss. Furthermore, when calls are exercised, the taxpayer's basis in the related stock is adjusted to reflect the price of the calls, reducing future long-term capital gains.

Like the neutral option hedge, the success of holding calls depends upon the stability of the underlying stock's price. If the stock continues to decline, the taxpayer's "double-dipping" on the stock will generate greater losses than desired. Unfortunately, all the taxpayer can do is sell his stock and take short-term loss. When the options expire he will get short-term capital gains treatment<sup>137</sup> on the premiums which he received. Generally speaking, these premiums will be insufficient to offset his short-term losses.

In a stable market the calls written in a neutral option hedge result generally in a profit while buying calls result generally in a slight loss. However, holding calls does have its advantages. By holding calls the taxpayer reduces his risk comparable to that achieved by the neutral option hedge without tying up nearly so much capital. Further, holding calls permits the taxpayer to benefit from any upward movement in the stock's price. Therefore, during the 30 day period when the taxpayer owns both options and the related stock any upward movement in the stock's price will be doubly to his benefit.

Third and finally, puts may be used to produce short-term losses while maintaining an investment position, despite section 1233's short sale restrictions. This method requires the taxpayer to sell his stock and to buy a deep-in-the-money put. In all probability this put will be exercised. If the writer exercises the put, the premium which the taxpayer received will reduce the basis in the stock acquired. Unfortunately, the repeated transactions necessary in this method often result in large commission charges. This causes deep-in-the-money puts to be an unattractive alternative for most investors. Nevertheless, they should be considered when neither the option hedge nor buying calls provides a satisfactory route for the taxpayer.

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137. INT. REV. CODE OF 1954, § 1234(a)(2).

*Generating Short-term Gain*

An investor may be in the position of having short-term capital loss but insufficient short-term gain to take full advantage of his loss.<sup>138</sup> The problem becomes how to generate short-term capital gain. Formerly, two possibilities<sup>139</sup> existed: writing in-the-money calls and writing straddles.

By characterizing both the losses generated from the lapse and the closing of options as short-term capital gain, the Act has sharply curtailed the efficacy of both devices. However, since both of these methods were popular tax-planning strategies, they must be examined. The taxpayer could write in-the-money calls<sup>140</sup> against his position in the stock, or alternatively against another option in a back spread. If the stock rose, it could be sold, generating capital gain. The losses produced by the stock option were deductible from ordinary income. Further, unless the stock's price dropped below the call's striking price, the writer could exercise the option. This resulted in the call's premium being added to the basis of the stock. The profits derived from these sales of the stock or options were capital gains. However, this particular method of generating short-term capital gain presented two major difficulties. First, the size of the capital gain was hard to gauge in advance. Second, the amount of capital required as well as the size of the brokerage fees were quite high in relation to the potential gains which could be generated. These factors may have provided a strong motivation to seek one's short-term gains elsewhere.

The safest and surest method of generating short-term capital gain was writing straddles. Until its recent amendment, section 1234(c) characterized any profit on an expired straddle as short-term gain. It was probable that some short-term gain would be produced. Unless the underlying stock was highly volatile, it was improbable that both sides of a straddle would be exercised.<sup>141</sup> Therefore, at bare minimum, a straddle ought to have generated short-term gains equal to the least valuable side of the straddle. Further, if the stock's price was reasonably stationary, the resulting short-term gain may be as high as the premiums from both

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138. See note 45 *supra*.

139. A third possibility is to trade commodity futures. A discussion of this alternative is beyond the scope of this article. See generally Kennedy, *Selecting the Off-beat Investments: Puts, Calls, Straddles, Warrants, Commodity Futures and Other Exotica*, N.Y.U. 32D INST. ON FED. TAX. 1093 (1972).

140. An in-the-money call is a call whose striking price is below the current fair market value of the stock.

141. See text accompanying notes 117 through 120 *supra*.

sides of the straddle. On the other hand, the investor was locked in. Having written a conventional straddle the taxpayer could only wait for the expiration of the options, being unable to close out the unfavorable side of the straddle and thereby limit his capital losses at a point of his own choosing.

Currently, puts are not traded on the various options exchanges. Individuals who want liquidity can deal only in hybrid straddles. A hybrid straddle requires the taxpayer to sell an exchange call to another investor and a conventional put to a converter. The converter then turns around and sells a second call. In this way either or both sides of the straddle may be closed affording the taxpayer greater protection from the vagaries of the marketplace. Unfortunately, the entire area of the hybrid straddle was *terra incognita*. One could make assumptions, but he would find neither case law nor revenue rulings directly on point. The assumption was that ordinary loss was generated on the repurchase of either side of a hybrid straddle.<sup>142</sup> If this was the case, the writer of a straddle could simultaneously obtain short-term capital gains treatment for any gains while obtaining ordinary loss treatment for any losses.

Needless to say, any tax planning device founded on so large an assumption was fraught with uncertainty. The Service could attack this reasoning in several ways. First, the Commissioner could contend that a "hybrid straddle" was not a straddle within the meaning of the unamended section 1234(c)(3). Section 1234(c)(3) defined a straddle as "a simultaneously granted combination of an option to buy, and an option to sell, the same quantity of a security at the same price during the same period of time."<sup>143</sup> Arguably, the hybrid straddle did not consist of a simultaneously granted put and call. Rather, it consisted of an exchange call and the subsequent acquisition of a conventional put. Second, the Service could argue that the congressional intent behind the former section 1234(c) was to ease the tax burden on parties dealing in conventional straddles and not those dealing in the liquid markets of the new options exchanges. Finally, the Commissioner could argue that the revenue rulings concerning repurchase did not extend to straddles. This argument was based on the fact that until hybrid straddles were developed, repurchase was impossible. The implications of these difficulties had to be weighed before advising the use of the hybrid straddle.

The taxpayer must still be aware of the non-tax difficulties in the use of straddles. Should the taxpayer be unable or unwilling to

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142. Special Ruling, April 8, 1974, 749 CCH 1974 STAN. FED. TAX. REP. ¶ 6597.

143. Act of Nov. 13, 1966, Pub. L. No. 89-809, § 210, 80 Stat. 1580.

close the unprofitable side of the straddle prior to the time that the stock moves away from the option's striking price, the taxpayer could suffer a loss even after considering the tax benefits. Should the stock's price fluctuate widely, the taxpayer could lose money in both the put and call side of the straddle. Finally, it is entirely possible that one side of the straddle may be exercised before the taxpayer can close it. Should this occur, the transactions' costs will rise resulting in a decline in the taxpayer's pre-tax profits.

The straddle was not without its advantages. If the price of the stock remained relatively stable, the taxpayer received ordinary income from that side of the straddle which was repurchased while receiving capital gain from that side of the straddle which was exercised. It was impossible to state the precise amount of short-term gain or ordinary income which any investment will produce. Yet straddles enabled the taxpayer to reduce his tax bill at relatively low cost and risk. Finally, unlike so much of the arcane world of options, straddles were often attractive investments as well as good tax-planning devices. If a straddle was written when the options were overpriced, short-term gains would exceed ordinary loss. No other method of transforming capital loss into ordinary loss afforded the taxpayer this additional benefit.

The Tax Reform Act of 1976 has eliminated the utility of these tax-planning strategies by characterizing the losses generated by the closing of an option as short-term losses. However, the Act also gives many of those taxpayers who are affected by this modification a break by characterizing gain on the closing of an option or on an option's lapse as short-term capital gain.<sup>143.1</sup> In addition, the Act alters section 1221(b) to increase the amount of the net capital loss which may be used to offset ordinary income.<sup>143.2</sup> Because of these two modifications, the necessity for the two aforementioned tax strategies has been greatly reduced.

#### *Short Position on the Underlying Stock*

While the tax planning strategies discussed thus far have related to taxpayers holding long positions in a stock, similar strategies exist for those individuals holding short positions.

A short sale's gain can be frozen by the purchase of a call.<sup>144</sup>

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143.1. See note 89 *supra*.

143.2. See note 45 *supra*.

144. A short sale may be used to freeze a call's short-term gain into long-term gain in much the same way as a call may be used to freeze this gain in a short sale. Rev. Rul. 58-384, 1958-2 CUM. BULL. 410, states that a call is not substantially identical to its related stock.

Should the stock's price remain stable or decline, the call need not be exercised. In this situation, the gain on the short sale may be either long or short-term depending upon the holding period of the stock sold short. Of course, the stock may appreciate in value. If this occurs, the call may be used to purchase stock with which to close the short sale. In this instance section 1233(b) would apply and gain would be characterized as short-term, but risk to the investor would be minimized. Additionally, if the price differentials dictate, the call may itself be sold and generate long or short-term gain depending upon its holding period.<sup>145</sup>

Similarly, a put's gain may be fixed by the purchase of its related stock. Section 1233(b) treats the acquisition of a put as if a short sale was involved. However, section 1233(b) appears to be limited in its application to those situations in which the put is exercised or allowed to lapse. If the sale of a put is beyond the scope of section 1233, then its paper profit can be frozen by purchasing the underlying stock. Since this requires a large capital outlay, one must consider whether it is better to try to generate this long-term gain or to simply accept the short-term gain and then reinvest elsewhere.

#### CONCLUSION

In the fourth century B.C., Sun Tze, a Chinese military strategist, stated, "Know yourself, know your enemy; Hundred wars, hundred victories."<sup>146</sup> This is sound tax strategy as well as military strategy. Puts, calls, straddles, and all of their combinations and permutations can add great flexibility to any investment plan. These options permit a taxpayer to reduce his tax burden and his investment risk simultaneously. However, a complete and satisfactory use of these options requires a full understanding of both the financial needs and expectations of the taxpayer as well as the tax consequences of the three Code sections: 1091, 1233, and 1234. By carefully considering the impact and implications of these Code sections as well as the needs of the individual many of the financial and tax difficulties which usually attend investment plans can be avoided.<sup>147</sup>

JOHN A. BERRY

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Thus, the characterization of long-term gain as short-term under the short sales provisions of section 1233 will not apply. Therefore, a short sale can freeze a call's profits until the call has been held long enough to realize long-term capital gains.

145. See text accompanying note 112 *supra*.

146. F.L.K. HSU, *AMERICANS AND CHINESE* 1 (1970).

147. Although this article was written prior to the enactment of the Tax Reform Act of 1976, both the text and the footnotes of the article have been changed to reflect the new provisions of the Code as they apply to the taxable year ending December 31, 1976.