Section 1092.—Straddles

26 CFR 1.1092(c)–1: Qualified covered calls.

T.D. 8990

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Equity Options With Flexible Terms; Qualified Covered Call Treatment

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations providing guidance on the application of the rules governing qualified covered calls. The new rules address concerns that were created by the introduction of new financial instruments several years after the enactment of the qualified covered call rules. The final regulations provide guidance to taxpayers writing equity call options.

DATES: *Effective Date*: These regulations are effective April 29, 2002.

Applicability Date: For dates of applicability, see §§ 1.1092(c)–1(c), 1.1092(c)–2(d), 1.1092(c)–3(c), and 1.1092(c)–4(g).

FOR FURTHER INFORMATION CONTACT: Pamela Lew, (202) 622–3950 or Viva Hammer, (202) 622–0869 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On January 18, 2001, the IRS published in the **Federal Register** proposed regulations (REG–115560–99, 2001–1 C.B. 993 [66 F.R. 4751]) addressing various issues concerning qualified covered call (QCC) options under section 1092(c)(4). No requests to speak at a public hearing were received, and no public hearing was held.

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

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

The proposed regulations further provide that equity options with standardized terms with maturities of longer than one year cannot be QCC options.

Comments were requested about the proposed one-year limit for all QCCs, including a discussion of time limitations in general. If a commentator recommended a time limitation greater than one year or recommended that there be no time limitation, a detailed, comprehensive description of possible solutions to the problem of increased risk reduction caused by longer term options was requested. Commentators were also asked to address the administrability of any proposed solutions.

After revisions to take into account several of the comments submitted, the proposed regulations are adopted by this Treasury decision.

Summary of Principal Comments

Four commentators responded to the request for comments. Two of the commentators addressed only the proposed 1-year limitation applicable to all QCC options. A third commentator addressed the proposed 1-year limit as well as a number of other issues. The fourth commentator focused on issues other than the proposed 1-year limitation.

One-year Term Limitation

A number of commentators object to the proposal to limit QCC treatment to options with a duration of one year or less. These commentators note that the statute does not contain any limitation on the maximum term for QCCs and argue that a one-year limitation would be overly harsh. Among other things, they note that a strict one-year rule would preclude QCC status for even out-of-the-money options. One commentator notes that section 1092(c)(4) does not remove a QCC option completely from the straddle rules. Paragraphs (c)(4)(E) and (f) of section 1092 provide special limitations on QCCs for recognition of loss and suspension of holding period.[1] This commentator suggests that these rules limit the extent to which longer-term QCCs would lead to results inconsistent with the purposes of section 1092.

In response to the request in the preamble to the proposed regulation for alternative regimes to address the

[1] Under section 1092(c)(4)(E), the exception for QCCs does not apply to a covered call that would otherwise qualify for the exception if one leg is disposed of at a loss in one year, gain on the other position is includible for a later year, and less than 30 days has elapsed between these transactions. Under section 1092(f), if a taxpayer grants an in-the-money QCC, then loss on the call is treated as long-term capital loss if gain on the underlying stock would be long-term capital gain. In addition, the holding period is suspended for the period during which the taxpayer is the grantor of the option.

increased risk reduction created by longer-term options, two commentators suggest an adjustment to the "applicable stock price" to reflect forward pricing concepts. These commentators suggest that the unadjusted applicable stock price, as determined on the date the option is granted, be multiplied by a simple adjusting factor to produce an applicable stock price adjusted for the passage of time. For each additional term year, the factor would be increased by 5%. For example, the factor for a one-to-two year option would be 105%, and the factor for a two-to-three year option would be 110 %. The adjusted applicable stock price would then be used to determine the applicable benchmarks and the lowest permitted QCC strike price. The commentators prefer, however, no limitation on the term of QCC options.

Clarification of "single fixed strike price"

Proposed § 1.1092(c)–1(c)(1)(ii) requires a QCC option to have "a single fixed strike price stated as a dollar amount." One commentator suggests that this phrase does not account for adjustments to the strike price due to certain corporate events, such as stock splits, stock dividends, spin-offs, mergers, or substantial cash dividends that reduce the market value of the stock by at least 10%. For example, a strike price might not be considered fixed if the underlying stock split two-for-one and the option's strike price were adjusted to one-half of its original strike price. The commentator recommends that the language be modified to account for these events.

Clarification That the Lowest Qualified Benchmark for a FLEX Option is the Same as for an Equity Option with Standardized Terms

Proposed § 1.1092(c)–1(c)(2)(i) provides that to determine whether a FLEX option is deep in the money, the taxpayer must use the same lowest qualified benchmark that is used for a standardized option on the same stock having the same applicable stock price. One commentator argues that the language in the proposed regulation is ambiguous. The commentator suggests that the language in the proposed regulation be changed to provide that the lowest qualified benchmark for a FLEX option is equal to the lowest *available* strike price at which a standardized call option can be written without being deep in the money.

Requirement That an Equity Option with Standardized Terms Exist at the Time an Equity Option with Flexible Terms or Qualifying Over-the-counter Option is Written

Under § 1.1092(c)–1(c)(1)(iv) of the proposed regulation, a FLEX option can be a QCC option only if "[a]n equity option with standardized terms is outstanding for the underlying equity." Under exchange rules, trading in a FLEX option cannot be *authorized* unless trading in a standardized option on the same stock has been *authorized*. Although a commentator believes it unlikely that a FLEX option would be written on a stock for which there were no outstanding standardized options, the commentator sees no reason to impose this restriction. Thus, the commentator recommends that the word "available" be substituted for the word "outstanding."

Clarification of "equity option with standardized terms"

Under proposed § 1.1092(c)–1(d)(3), an equity option with standardized terms is defined as "an equity option that is traded on a national securities exchange registered with the Securities and Exchange Commission and that is not an equity option with flexible terms." One commentator notes that there is no definition of "equity option" and wonders whether the definition of equity option in section 1256(g) applies here. That definition would include options on narrow based indexes. In addition, because an equity option with standardized terms is defined as a negative (*i.e.*, anything that is not a FLEX option), if the exchanges approve a new option product that does not meet the definition of FLEX option, that product might meet the definition of a standardized option, thus affecting the application of the regulations for FLEX options. The commentator did not provide alternative regulatory language.

Clarification of "entered into with"

Under proposed § 1.1092(c)–3(c)(2)(i), a qualifying OTC option must be "entered into with" a person registered with the SEC as a broker-dealer. One commentator is concerned that this phrase implies that the broker-dealer must act as a principal in the transaction. The commentator requests that the language be modified to say that the broker-dealer may be a principal to the transaction or may serve as an agent.

Add Banks to the List of Parties With or Through Whom a QCC May Be Transacted

One commentator requests that banks be added to the list of parties with or through whom a QCC transaction may be effected. The commentator notes that under the Gramm-Leach-Bliley Act, Public Law 106–102, 113 Stat. 1338 (1999), banks will be required to interpose a broker-dealer registered with the SEC in transactions with customers who are not "qualified investors." Banks will be permitted to function as broker-dealers with respect to "qualified investors."

The commentator suggests defining a bank as a "bank within the meaning of section 3(a)(6) of the Securities Exchange Act of 1934 and the regulations adopted thereunder." The commentator argues that any such bank would be subject to a banking regulatory authority within the United States and would generally be subject to recordkeeping requirements.

Explanation of Provisions

Limitation of Option Term

As originally enacted in 1981, section 1092 did not apply to stock or to options on stock. In the legislative history to the Tax Reform Act of 1984, the House Ways and Means Committee stated that taxpayers had attempted to exploit the exemption from the loss-deferral rule for exchange-traded stock options to defer tax on income from unrelated transactions. H. Rep. No. 432, 98th Cong., 2d Sess. 1266 (1984). The Committee stated that a typical abusive stock option straddle "involves the acquisition of 'deep-in-the-money' offsetting option positions. Regardless of whether the

value of the underlying stock increases or decreases, one option position will result in a loss that can be realized for tax purposes, while the other position results in a gain of approximately equal size that can be deferred until the next year." *Id.* In response to these concerns, Congress generally ended the exemption from the straddle rules for stock and exchange-traded options.

The House Ways and Means Committee noted, however, that the extension of the straddle rules to stock options and stock would affect the widely used investment strategy of writing call options on stock owned by the taxpayer. The Committee stated that it might be appropriate to exempt transactions that were 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. Congress therefore amended section 1092 to permit a taxpayer owning stock and writing a covered call option generally to avoid straddle treatment if certain conditions were met. One condition was that the strike price of the call could not be less than a statutorily-prescribed level relative to the market price of the underlying stock. In establishing this exception to the straddle rules, Congress granted the Secretary broad regulatory authority to modify section 1092 to take account of changes in the practices of options exchanges or to prevent tax avoidance.

Since 1984, numerous changes have occurred in the practices of options exchanges. In 1984, no exchange-traded option had a term of greater than nine months. By contrast, certain exchange-traded options currently may have terms of up to 33 months. In light of these changes, the IRS and Treasury have considered certain economic characteristics of qualified covered call transactions as they relate to the risk reduction effects of longer-term options.

One way of looking at the risk reduction effect of a covered call option focuses on the day-to-day (or intra-day) relative changes in value of the stock and the option. In general, the values of stock and a written call option on the stock vary inversely when viewed from the perspective of the person owning the stock and writing a call option. Each movement in the stock price produces a movement in the value of the written call that, at least partially, offsets the change in value of the long position in the stock.

Modern option pricing literature describes this relationship between the change in value of the underlying stock and the change in value of the option using the parameter "Delta". If a change in value of the stock results in an equal movement in the value of the option, Delta equals 1. If the change in value of the option is less than the change in value of the stock, then Delta is less than 1. From the perspective of a call option writer, because of the inverse relationship between changes in stock price and changes in option value described above, Delta represents the amount of offset that a change in stock value has upon the value of the written call option. Delta values vary with a number of factors, including the extent to which the option is in or out of the money and the term of the option. All else being equal, longer-term options have higher Delta values and, therefore, have a greater risk reduction potential than short-term options with respect to movements in stock prices.

Another economic characteristic of longer-term covered call options is increased potential for the immediate recognition of a stock loss and the deferral of any gain arising from a related option. As noted above, when section 1092(c)(4) was enacted, no qualified covered call option had a term of more than nine months, and the mismatch for a QCC thus could not have spanned more than one taxable year. With the advent of longer-term options, the potential for a mismatch between a loss and the deferral of related income can extend over many taxable years, which may not have been contemplated by Congress when the QCC provisions were enacted.

After reviewing taxpayers' comments received in light of these economic considerations, the IRS and Treasury have decided to adopt a forward pricing approach for the determination of the applicable stock price for an option with a term greater than 12 months. To determine the applicable stock price for an option with a term greater than 12 months, taxpayers are required to multiply the statutory applicable stock price by a factor, which represents a noncompounded two percent per quarter increase in the applicable strike price. Based on certain assumptions regarding the volatility of the underlying stock and the risk-free interest rate, the use of such factors for options with a relatively short term (*i.e.*, 33 months or less) will produce Deltas that are generally similar to those for a nine-month option with no adjustment to the applicable strike price. Because no exchange-traded option currently has a term of more than 33 months, and because the application of the approach set forth above to options with terms longer than 33 months may permit the use of such options for tax avoidance, the IRS and Treasury believe that it would be inappropriate to extend this approach to such options. Thus, no option will constitute a qualified covered call option if it has a term of greater than 33 months. Additional guidance about the maximum term limit may be provided by the Commissioner in guidance published in the Internal Revenue Bulletin. This could occur, for example, if the option exchanges commence trading of equity options with standardized terms that expire more than 33 months after the date of issuance.

The definition of a QCC option also affects a number of other Code sections. These are generally provisions that require a taxpayer to bear economic risk with respect to an asset for purposes of establishing a requisite holding period in the asset. See sections 246(c)(1), 852(b)(4)(C), 857(b)(8)(B), 901(k)(5), 1059(d)(3), and 1259(c)(3)(A)(iii). The IRS and the Treasury have taken into account the interaction of the QCC qualification rules and these other Code sections in light of the risk reduction potential of longer-term options. If, however, experience suggests that longer-term QCC options are being exploited to achieve risk reduction while allowing taxpayers to establish holding periods in ways that are inconsistent with another Code provision (*e.g.*, section 1259), the IRS and Treasury may reconsider the issue of term limitations for QCCs, either generally for purposes of section 1092 or specifically for purposes of such other Code provision.

Clarification of "single fixed strike price"

After consideration of the comment submitted, a definition for "single fixed strike price" is added at § 1.1092(c)–4(d), providing that adjustments to the strike price for certain significant corporate events subsequent to the writing of the option will not cause the option to fail the requirement of a single fixed strike price. The definition is intended to cover adjustments to the strike price made under Section 11 of Article VI of the Options Clearing Corporation By-Laws.

Clarification That the Lowest Qualified Benchmark for a FLEX Option is the Same as for an Equity Option with Standardized Terms

After consideration of the comment submitted, examples have been added at § 1.1092(c)–2(c)(2)(ii) to clarify that the lowest qualified benchmark for a FLEX option is the same as the lowest qualified benchmark for an equity option with standardized terms on the same stock having the same applicable stock price.

Requirement That an Equity Option with Standardized Terms Exist at the Time an Equity Option with Flexible Terms or Qualifying Over-the-counter Option is Written

After consideration of the comment submitted, the language is finalized as proposed.

This provision was inserted in the proposed regulation for two reasons. The first reason was to provide benchmarks for FLEX options. Because FLEX option strike prices can be written in one penny intervals, without this provision every FLEX option would be deep-in-the-money if the strike price were one penny less than the applicable stock price. By tying every FLEX option to a standardized option, the benchmarks are the strike prices set by the exchanges for standardized options. For this purpose, an authorized standardized option would suffice.

The second reason underlying this provision is to facilitate the discovery of attempts to use off-market pricing of FLEX options or qualifying OTC options as a method of effecting collateral transactions. If a FLEX option or qualifying OTC option were written for an off-market premium, that would warn of the potential for the existence of one or more other transactions. For example, a qualifying OTC option might be written by a corporation and held by a shareholder. If the premium were excessively low compared to that for a standardized option on that same stock, the additional value received by the holder might be appropriately characterized as a dividend. Thus, with an outstanding standardized option on the same stock, the existence of an excessively low premium for a FLEX option would be more transparent.

Clarification of "equity option with standardized terms"

After consideration of the comment submitted, a new definition for "equity option with standardized terms" is provided at § 1.1092(c)–4(b). The factors listed in this section were based on the rules of the exchanges establishing required provisions of exchange-traded equity options.

Clarification of "entered into with"

After consideration of the comment submitted, a clarification is added to § 1.1092(c)–4(c)(2)(i) to explain that the broker-dealer may be a principal to the transaction or can serve as an agent.

Add Banks to the List of Parties With or Through Whom a QCC May Be Transacted

After consideration of the comment submitted and review of the recordkeeping requirements of 12 CFR 12.3, 12 CFR 208.34, and 12 CFR 344.4, banks that are required to comply with these recordkeeping requirements are added to the list of parties with or through whom a qualifying over-the-counter option may be transacted.

Other Provisions

Section § 1.1092(c)–1 was redesignated § 1.1092(c)–2 to facilitate the insertion of the general term limitations applying to all QCC options. The definitions in former § 1.1092(c)–1(d) were moved to § 1.1092(c)–4 to facilitate consolidation of definitions that apply to QCC options.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the only category of small entities likely to be affected are small broker-dealers or small federally-regulated financial institutions who may be included among the financial intermediaries implementing the changes effected by these regulations. The requirements contained in these regulations do not impose more than a minimal compliance burden because the required changes in computer programs and back office procedures are insignificant. In addition, these regulations do not impose any recordkeeping or reporting requirements and therefore impose minimal compliance costs, if any, upon any small entities that may be affected. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Drafting Information

The principal authors of these regulations are Pamela Lew, Office of Associate Chief Counsel (Financial Institutions and Products) and Viva Hammer, Office of Tax Policy (Department of Treasury). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

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

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

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

Par. 2. Section 1.1092(c)–1 is redesignated as § 1.1092(c)–2.

Par. 3. A new § 1.1092(c)–1 is added to read as follows:

§ 1.1092(c)–1 Qualified covered calls.

(a) *In general*. Section 1092(c) defines a straddle as offsetting positions with respect to personal property. Under section 1092(d)(3)(B)(i)(I), stock is personal property if the stock is part of a straddle that involves an option on that stock or substantially identical stock or securities. Under section 1092(c)(4), however, writing a qualified covered call option and owning the optioned stock is not treated as a straddle under section 1092 if certain conditions, described in section 1092(c)(4)(B), are satisfied. Section 1092(c)(4)(H) authorizes the Secretary to modify these conditions to carry out the purposes of section 1092(c)(4) in light of changes in the marketplace.

(b) *Term limitation*—(1) *General rule*. Except as provided in paragraph (b)(2) of this section, an option is not a qualified covered call unless it is granted not more than 12 months before the day on which the option expires or satisfies term limitation and qualified benchmark requirements established by the Commissioner in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter).

(2) *Special benchmark rule for an option granted not more than 33 months before the day on which the option expires* (i) *In general*. The 12-month limitation described in paragraph (b)(1) of this section is extended to 33 months provided the lowest qualified benchmark is determined using the adjusted applicable stock price, as defined in § 1.1092(c)–4(e).

(ii) *Examples*. The following examples illustrate the rules set out in paragraph (b)(2)(i) of this section:

Example 1. Taxpayer owns stock in Corporation X. Taxpayer writes an equity option with standardized terms on Corporation X stock through a national securities exchange with a term of 21 months. The applicable stock price for Corporation X stock is $100. The bench marks for a 21-month equity option with standardized terms with an applicable stock price of $100 will be based upon the adjusted applicable stock price. Using the table at § 1.1092(c)–4(e), the applicable stock price of $100 is multiplied by the adjustment factor 1.12, resulting in an adjusted applicable stock price of $112. Using the bench marks for an equity option with standardized terms with an adjusted applicable stock price of $112, the highest available strike price less than the adjusted applicable stock price is $110, and the second highest strike price less than the adjusted applicable stock price is $105. Therefore, a 21-month equity call option with standardized terms on Corporation X stock will not be deep in the money if the strike price is not less than $105.

Example 2. Taxpayer owns stock in Corporation Y. Taxpayer writes an equity option with standardized terms on Corporation Y stock through a national securities exchange with a term of 21 months. The applicable stock price for Corporation Y stock is $13.25. The bench marks for a 21-month equity option with standardized terms with an applicable stock price of $13.25 will be based upon the adjusted applicable stock price. Using the table at § 1.1092(c)–4(e), the applicable stock price of $13.25 is multiplied by the adjustment factor 1.12, resulting in an adjusted applicable stock price of $14.84. Using the bench marks for an equity option with standardized terms with an adjusted applicable stock price of $14.84, the highest available strike price less than the adjusted applicable stock price is $12.50. However, under section 1092(c)(4)(D), the lowest qualified bench mark can be no lower than 85% of the applicable stock price, which for Corporation Y stock is $12.61 (85% of the adjusted applicable stock price of $14.84). Thus, because the highest available strike price less than the adjusted applicable stock price for an equity option with standardized terms is lower than the lowest qualified bench mark under section 1092(c)(4)(D), the lowest strike price at which a qualified covered call option can be written is the next higher strike price, or $15.00. Therefore, a 21-month equity call option with standardized terms on Corporation Y stock will not be deep in the money if the strike price is not less than $15.

(c) *Effective date*. This section applies to qualified covered call options entered into on or after July 29, 2002.

Par. 4. Section 1.1092(c)–4 is added to read as follows:

§ 1.1092(c)–4 Definitions.

The following definitions apply for purposes of §§ 1.1092(c)–1 through 1.1092(c)–3:

Par. 5. Section 1.1092(c)–2 is amended as follows:

1. Paragraph (b) is revised.
2. Paragraph (c) is added.
3. The paragraph in § 1.1092(c)–2 indicated in the first column is redesignated as a paragraph in § 1.1092(c)–4 as indicated in the second column as follows:

§ 1.1092(c)–2	§ 1.1092(c)–4
(d)(1) introductory text	(a) introductory text
(d)(1)(i) introductory text	(a)(1) introductory text
(d)(1)(i)(A)	(a)(1)(i)
(d)(1)(i)(B)	(a)(1)(ii)
(d)(1)(i)(C)	(a)(1)(iii)
(d)(1)(i)(D)	(a)(1)(iv)
(d)(1)(ii) introductory text	(a)(2) introductory text
(d)(1)(ii)(A)	(a)(2)(i)
(d)(1)(ii)(B)	(a)(2)(ii)
(d)(2)	(f)

4. Paragraph (d) is revised.
5. Paragraph (e) is removed.

The revisions and additions read as follows:

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

* * * * *

(b) *No effect on lowest qualified bench mark for standardized options*. The availability of strike prices for equity options with flexible terms does not affect the determination of the lowest qualified bench mark, as defined in section 1092(c)(4)(D), for an equity option with standardized terms.

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

(i) The option meets the requirements of section 1092(c)(4)(B) and § 1.1092 (c)–1 (taking into account paragraph (c)(2) of this section);

(ii) The only payments permitted with respect to the option are a single fixed premium paid not later than 5 business days after the day on which the option is granted, and a single fixed strike price, as defined in § 1.1092(c)–4(d), that is payable entirely at (or within 5 business days of) exercise;

(iii) An equity option with standardized terms is outstanding for the underlying equity; and

(iv) The underlying security is stock in a single corporation.

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

(ii) *Examples*. The following examples illustrate the rules set out in paragraph (c)(2)(i) of this section:

Example 1. Taxpayer owns stock in Corporation X. Taxpayer writes an equity call option with flexible terms on Corporation X stock through a national securities exchange for a term of not more than 12 months. The applicable stock price for Corporation X stock is $73.75. Using the bench marks for an equity option with standardized terms with an applicable stock price of $73.75, the highest available strike price less than the applicable stock price is $70, and the second highest strike price less than the applicable stock price is $65. Therefore, an equity call option with flexible terms on Corporation X stock with a term of 90 days or less will not be deep in the money if the strike price is not less than $70. If the term is greater than 90 days, an equity call option with flexible terms on Corporation X will not be deep in the money if the strike price is not less than $65.

Example 2. Taxpayer owns stock in Corporation Y. Taxpayer writes a 9-month equity call option with flexible terms on Corporation Y stock through a national securities exchange. The applicable stock price for Corporation Y stock is $14.75. Using the bench marks for an equity option with standardized terms with an applicable stock price of $14.75, the highest available strike price less than the applicable stock price is $12.50. However, under section 1092(c)(4)(D), the lowest qualified bench mark can be no lower than 85% of the applicable stock price, which for Corporation Y stock is $12.54. Thus, because the highest available strike price less than the applicable stock price for an equity option with standardized terms is lower than the lowest qualified bench mark under section 1092(c)(4)(D), the lowest strike price at which a qualified covered call option can be written is the next higher strike price, or $15.00. This $15.00 strike price requirement for a qualified covered call option applies to equity options with flexible terms, equity options with standardized terms, and qualifying over-the-counter options.

Example 3. Taxpayer owns stock in Corporation Z. On May 8, 2003, Taxpayer writes a 21-month equity call option with flexible terms on Corporation Z stock through a national securities exchange. The applicable stock price for Corporation Z stock is $100. The bench marks for a 21-month equity option with standardized terms with an applicable stock price of $100 will be based upon the adjusted applicable stock price. Using the table at §1.1092(c)–4(e), the applicable stock price of $100 is multiplied by the adjustment factor 1.12, resulting in an adjusted applicable stock price of $112. The highest available strike price less than the adjusted applicable stock price is $110, and the second highest strike price less than the adjusted applicable stock price is $105. Therefore, a 21-month equity call option with flexible terms on Corporation Z stock will not be deep in the money if the strike price is not less than $105.

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

(2) *Effective date for paragraphs (b) and (c) of this section*. Paragraphs (b) and (c) of this section apply to equity options with flexible terms entered into on or after July 29, 2002.

Par. 6. Section 1.1092(c)–3 is added to read as follows:

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

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

(b) *Qualified covered call option status*. A qualifying over-the-counter option, as defined in § 1.1092(c)–4(c), is a qualified covered call option if it meets the requirements of §§ 1.1092(c)–1 and 1.1092(c)–2(c) after using the language “qualifying over-the-counter option” in place of “equity option with flexible terms”. For purposes of this paragraph (b), a qualifying over-the-counter option is deemed to satisfy the requirements of section 1092(c)(4)(B)(i).

(c) *Effective date*. This section applies to qualifying over-the-counter options entered into on or after July 29, 2002.

Par. 7. Section 1.1092(c)–4 is further amended as follows:

1. Newly designated paragraphs (a)(1)(iv), (a)(2) introductory text, and (a)(2)(i) are revised.
2. Paragraphs (b), (c), (d), (e), and (g) are added.

The revisions and additions read as follows:

§ 1.1092(c)–4 Definitions.

* * * * *

(a) * * *
(1) * * *
(iv) Any changes to the Security Exchange Act Releases described in paragraphs (a)(1)(i) through (iii) of this section that are approved by the Securities and Exchange Commission; or

(2) That is traded on any national securities exchange that is registered with the Securities and Exchange Commission (other than those described in the Security Exchange Act Releases set forth in paragraph (a)(1) of this section) and is—

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

* * * * *

(b) *Equity option with standardized terms* means an equity option—

(1) That is traded on a national securities exchange registered with the Securities and Exchange Commission;

(2) That, on the date the option is written, expires on the Saturday following the third Friday of the month of expiration;

(3) That has a strike price that is set at a uniform minimum strike price interval, that is established by the applicable national securities exchange registered with the Securities and Exchange Commission, and that is not less than $1.00; and

(4) That has stock in a single corporation as its underlying security.

(c) *Qualifying over-the-counter option* means an equity option that—

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

(2) Is entered into with—

(i) A broker-dealer, acting as principal or agent, who is registered with the Securities and Exchange Commission under section 15 of the Securities Act of 1934 (15 U.S.C. 78a through 78mm) and the regulations thereunder and who must comply with the recordkeeping requirements of 17 CFR 240.17a–3; or

(ii) An alternative trading system under 17 CFR 242.300 through 17 CFR 242.303; or

(iii) A person, acting as principal or agent, who must comply with the recordkeeping requirements for securities transactions described in 12 CFR 12.3, 12 CFR 208.34, or 12 CFR 344.4.

(d) *Single fixed strike price* means a strike price that is fixed, determinable, and stated as a dollar amount on the date the option is written. An option will not fail to have a single fixed strike price if, after the date the option is written, the strike price is adjusted to account for the effects of a dividend, stock dividend, stock distribution, stock split, reverse stock split, rights offering, distribution, reorganization, recapitalization, or reclassification with respect to the underlying security, or a merger, consolidation, dissolution, or liquidation of the issuer of the underlying security.

(e) *Adjusted applicable stock price* means the applicable stock price, as defined in section 1092(c)(4)(G), adjusted for time. To determine the adjusted applicable stock price, the applicable stock price, which is determined in accordance with the rules in section 1092(c)(4)(G), is multiplied by an adjustment factor. The adjustment factor table is as follows:

Option Term		Adjustment Factor
Greater Than	Not More Than	
12 months	15 months	1.08
15 months	18 months	1.10
18 months	21 months	1.12
21 months	24 months	1.14
24 months	27 months	1.16
27 months	30 months	1.18
30 months	33 months	1.20

* * * * *

(g) *Effective dates*. (1) Except for paragraph (a)(2) of this section, paragraph (a) of this section applies to equity options with flexible terms entered into on or after January 25, 2000. Paragraph (a)(2) of this section applies to equity options with flexible terms entered into on or after July 29, 2002.

(2) Paragraphs (b), (c), (d), and (e) of this section apply to equity options entered into on or after July 29, 2002.

(3) Paragraph (f) of this section applies to equity options entered into on or after January 25, 2000.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved April 12, 2002.

Mark A. Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on April 26, 2002, 8:45 a.m., and published in the issue of the Federal Register for April 29, 2002, 67 F.R. 20896)