

TAX TREATMENT OF CERTAIN OPTION INCOME OF
EXEMPT ORGANIZATIONS

 AUGUST 26, 1976.—Ordered to be printed

Mr. LONG, from the Committee on Finance,
submitted the following

REPORT

[To accompany H.R. 3052]

The Committee on Finance, to which was referred the bill (H.R. 3052) to amend section 512(b) (5) of the Internal Revenue Code of 1954 with respect to the tax treatment of the gain on the lapse of options to buy or sell securities, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

I. SUMMARY

The bill (H.R. 3052) deals with the application of the unrelated business income tax to income which an exempt organization receives from writing options to buy or sell securities in cases where the option is allowed to lapse, or is terminated. Under present law, premiums received for options which are "exercised" are treated as part of the gain or loss on the sale of the property involved—that is, usually as capital gain or loss. However, premiums for options which are allowed to lapse or are terminated generally are treated as ordinary income. In the case of most exempt organizations, capital gains—which include premiums from exercised options—are excluded from the unrelated business income tax as a part of the general exclusion for these organizations' investment income. In addition, most tax-exempt organizations are not taxed on dividend or interest income. This bill adds gains from the lapse or termination of options to buy or sell securities to the exempt category of income for exempt organizations (except for those categories of organizations taxed on investment income). This bill does not change the treatment of exercised options.

II. GENERAL STATEMENT

Present law

With the exception of social clubs and employees' beneficiary associations,¹ the investment income of exempt organizations generally is not subject to the tax on unrelated business income.² The types of investment income sources listed as being free of this tax include dividends, interest, annuities, royalties, and capital gains from the sale of investment assets.

The tax treatment of income which an exempt organization receives from writing options to buy or sell securities depends on whether the option is exercised, lapses, or is terminated. If a "call" option written by an exempt organization on a security in connection with its investment activities is exercised and the security is required to be sold by the exempt organization, the premium received for the option is treated as part of the gain or loss from the sale of the security. In this case the entire gain on the sale—including the premium on the option—realized by the exempt organization is free of tax because under present law (sec. 512(b)(5) of the Internal Revenue Code of 1954) the term "unrelated business taxable income" excludes all gains or losses from the sale, exchange, or other disposition of property (except in the case of inventory and property held for sale to customers). Similarly, if a "put" option written on the security in connection with an exempt organization's investment activities is exercised and the security is required to be purchased by the exempt organization, the premium income received for the option is treated as reducing the purchase price of the security. Subsequently, if the security is sold, this reduced purchase price means a larger capital gain (or smaller capital loss) on the sale of the security, which, as noted above, is excluded from the tax base of the exempt organization.

On the other hand, if an option written by the exempt organization (in the case of either a put or a call) is not exercised and the option lapses, the premium which the exempt organization receives generally is treated as ordinary income rather than as income from the sale of property.³ As a result, the premium received by an exempt organiza-

¹ In this report further references to "exempt organizations" do not include these two categories (secs. 501(c)(7) and (9)).

² In the case of "debt-financed property", different rules apply and the investment income may be taxable in part. Those rules are dealt with under section 514 of the Internal Revenue Code of 1954 and are not amended by this bill.

Also, private foundations are taxed on investment income under section 4940. This bill does not change the rules with regard to that tax.

³ Present law (sec. 1234(a)) provides that gain or loss in the case of the sale or exchange of an option is to be given the same treatment as would the gain or loss on the sale of the property to which the option relates. However, under sec. 1234(b), if the option holder fails to exercise the option, this provision indicates that only in the case of a loss is the failure to be treated as having the same character as the underlying property. Where there is a gain on the failure to exercise an option, the regulations provide (sec. 1.1234-1(b)) that this gain represents ordinary income to the writer of the option (even though the payment of the premium by the holder of the lapsed option results in a capital loss to that holder). In private letter rulings, the Service has held that an option writer's gain from the expiration or lapse, and his gain or loss from a closing transaction on an option is ordinary income or loss.

Under present law (sec. 1234(c)) gain from the lapse of an option written as part of a "straddle" (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, is treated as gain from the sale or exchange of a capital asset held for not more than 6 months on the date that the option expired (see Treas. Regs. § 1X1234-2(f), example (3)). Consequently, option lapse income from "straddles" is already excluded from unrelated business taxable income of exempt organizations (other than in the case of social clubs, employees' beneficiary associations, and private foundations, and other than in the case of debt-financed property, as noted above).

tion on a lapsed option generally is subject to the unrelated business income tax.

Until recently, put and call options were traded exclusively "over-the-counter" through put and call brokers. The over-the-counter options are contracts between the specific buyer and specific writer. This means that while the buyer can exercise his option any time he wishes, the writer cannot terminate his obligation except by repurchasing the specific option he has written.

In 1973, trading began on listed options on the Chicago Board Options Exchange (CBOE). Unlike over-the-counter options, listed options consist of two contracts—one between the buyer and the CBOE and the other between the writer and the CBOE. A writer of a listed option can terminate his obligation by buying a listed option identical to the one he has written. This is called a "closing purchase transaction." The CBOE then cancels the two identical options. Currently the CBOE, the American Stock Exchange and the Philadelphia-Baltimore-Washington Stock Exchange all list call options, and they are expected soon to begin trading put options. Gain on an offsetting "closing purchase transaction" is also treated as ordinary income under present law.

Reasons for change

An option writer can foresee whether the purchaser (holder) will exercise the option. In addition, a writer may determine that its economic interest is best served by executing a closing purchase transaction on an option which it has written. The committee believes that it is inappropriate to tax income from options which are written by exempt organizations and which lapse or are terminated, as unrelated business income merely because such lapse or termination income is categorized as ordinary income. Taxing such income is inconsistent with the generally tax-free treatment accorded to exempt organizations' income from investment activities.

Explanation of bill

The bill amends present law (sec. 512(b)(5)) to exclude from the term "unrelated business taxable income" all gains on the lapse or termination of options to buy or sell securities,⁴ when the options have been written in connection with the exempt organization's investment activities. The rule of the bill is to apply, whether or not the option is "covered". Thus, the term "unrelated business taxable income" is to exclude all premiums received by an exempt organization on options which it writes under these circumstances, regardless of whether the option is exercised, lapses, or is terminated.

This bill has the effect of overriding for the future a 1966 Internal Revenue Service ruling⁵ that "income realized by the organization from unexercised 'call' options is * * * subject to the unrelated business income tax * * *. It is immaterial that income received by the organization from the sale of securities resulting from exercised op-

⁴ For this purpose, the definition of a security is that provided by section 1236(c) of the Code, as "any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence or an interest in or right to subscribe to or purchase any of the foregoing."

⁵ Rev. Rul. 66-47, 1966-1 CB 149.

tions is excluded from the base of the unrelated business income by section 512(b) of the Code.”

It is not intended that this treatment be available if the exempt organization writing the options takes such an active role in this activity that its options can be regarded as inventory or as being held for sale to customers in the ordinary course of its trade or business, or if the underlying securities on which the options are written constitute inventory or are being held for sale, etc.; such activities go beyond the concept of production of investment income that is intended to be exempted. Also, it is not intended that this bill detract from the court's decision in *Randall Foundation v. Riddell*, that securities trading can be so large a part of the activities of an organization that the organization fails to meet the statutory test of being “organized and operated exclusively for religious, charitable, scientific,” etc., purposes and thus does not qualify for exemption from tax.

Effective date

This amendment applies to gains from options which lapse or are terminated after January 1, 1976, regardless of whether the exempt organization involved is a calendar year taxpayer or a fiscal year taxpayer.

III. COSTS OF CARRYING OUT THE BILL AND VOTE OF THE COMMITTEE IN REPORTING H.R. 3052

Revenue cost

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the costs incurred in carrying out H.R. 3052. The committee estimates that this bill will have at most a small effect (under \$1,000,000) on the revenues. The Treasury Department agrees with this statement.

In accordance with section 403 of the Congressional Budget Act of 1974, the Director of the Congressional Budget Office has not made an estimate or comparison of the estimates of the cost of H.R. 3052, but has examined the committee's estimates and agrees with the methods and the dollar estimates resulting therefrom.

Vote of the committee

In compliance with section 133 of the Legislative Reorganization Act of 1946, the following statement is made relative to the vote by the committee on the motion to report the bill H.R. 3052, was ordered reported by a voice vote.

Tax expenditures

With respect to the effects of the committee amendment on tax expenditures during the next five fiscal years, the following statement is made:

In accordance with section 308(a)(2) of the Congressional Budget Act of 1974, after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by this bill involve no new budget authority or new or increased tax expenditures.

IV. CHANGES IN EXISTING LAW

In compliance with subsection 4 of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italics, existing law in which no change is proposed is shown in roman) :

INTERNAL REVENUE CODE OF 1954

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SUBTITLE A—INCOME TAXES

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CHAPTER 1—NORMAL TAXES AND SURTAXES

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PART III—TAXATION OF BUSINESS INCOME OF CERTAIN EXEMPT ORGANIZATIONS

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SEC. 512. UNRELATED BUSINESS TAXABLE INCOME.

(a) * * *

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(b) MODIFICATIONS.— * * *

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(5) There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than—

(A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or

(B) property held primarily for sale to customers in the ordinary course of the trade or business.

There shall also be excluded all gains on the lapse or termination of options, written by the organization in connection with its investment activities, to buy or sell securities (as defined in section 1236(c)). This paragraph shall not apply with respect to the cutting of timber which is considered, on the application of section 631, as a sale or exchange of such timber.

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