

linked to the activities of that permanent establishment. In this latter case the same criteria, as discussed in the case of UK companies, will be used to determine whether the profit should be treated as forming part of the company's trading activities or whether it should be treated as being of a non-trading nature.

Whether or not the contract relates to activities that are linked to a UK permanent establishment, no UK withholding tax will arise if the other party to the contract is within the charge to UK tax.

## VI. VAT

The grant of the option will be treated as an exempt supply for VAT purposes where the counterparty is resident in the European Community, or as a supply outside the scope of VAT, but on which it is possible to reclaim associated VAT input tax, where the counterparty is resident elsewhere.

## UNITED STATES

# Taxation of Index Options

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## I. INTRODUCTION

This article provides an overview of the federal income tax treatment of the proceeds arising from certain types of index options, both in the hands of the holder and in the hands of the writer. The contracts covered by this article include: index options, Asian options, end-end options, cliquet options, multi-cliquet options, look-back options, lock-in options, and step-up options. Before analysing the tax treatment of these various options, it is important to understand the general tax treatment of basic equity options.

## II. OPTIONS IN GENERAL

For federal income tax purposes, an option contract is defined as an agreement giving the holder the right, but not the obligation, to buy or sell a specified item, at any time until a future date (American) or at a fixed future date (European).<sup>2</sup> There are two basic types of options, namely put options and call options. A put option permits the holder of the option to deliver property to the writer of the option at an agreed price (known as the strike price). A call option permits the holder to purchase property from the writer at the strike price. Options may be cash settled, so that rather than delivering property upon exercise of the option, a cash payment is made equal to the difference between the strike price of the underlying item and the market value of that item at the time the option is to be exercised. In exchange for granting the option, the writer receives a premium that is generally paid at the time the option is entered into.

Options can either be listed on an exchange or purchased over-the-counter. The option holder or option purchaser

can generally lose no more than the premium paid for the option, and has unlimited gain potential. The option writer or option seller is obligated to perform if the holder exercises the option. The writer's gain is generally limited to the amount of premium received, and the writer has unlimited potential for losses.

Section 1234 of the Internal Revenue Code<sup>3</sup> sets forth the basic income and loss characterization rules governing options. For purchasers of options, gain or loss attributable to the sale or exchange, or loss attributable to the failure to exercise an option is characterized as gain or loss from property that has the same character as the property to which the option relates.<sup>4</sup>

In addressing the tax treatment of index options, there are three general characteristics that will determine how an option will be taxed. Timing determines when gain or loss will be recognized, while character determines whether gain or loss is ordinary or capital. This distinction is especially important for individuals because long-term capital gain income is taxed at a lower rate than ordinary income. Also, capital losses can only offset capital gain income (except for a small amount of permissible cross-character offset), thus limiting the use of such losses. Finally, source determines whether gain or loss will be taxable in the United States at source.

1. PricewaterhouseCoopers, New York.

2. See Rev. Rul. 94-63, 1994-2 CB 188.

3. All statutory references are to the Internal Revenue Code of 1986, as amended. All references to regulations (e.g. "Treas. Reg. Sec.") are to the treasury regulations promulgated under the Internal Revenue Code.

4. Sec. 1234(a).

## A. General tax treatment of writer

Premiums received by an option writer are not included in income at the time of receipt; rather, they are carried forward in a deferred account until:

- the writer's obligation expires through the passage of time;
- the writer sells the underlying stock or pays cash pursuant to the exercise of the option; or
- the writer engages in a closing transaction.

A closing transaction is defined as "any termination of the taxpayer's obligation under an option in property other than through the exercise or lapse of the option".<sup>5</sup>

Upon exercise, the writer recognizes gain or loss equal to the difference between (1) the writer's basis in the optioned property and (2) the sum of the option strike price plus the option premium. Gain or loss to the writer from the sale of an option is the difference between the premium and any amount paid to the party assuming the writer's obligations under the option. Gain to the writer on termination of an option is equal to the difference between the premium and any amount paid for the termination. The writer's gain from the lapse of an option is equal to the amount of the premium.

Gain or loss that is recognized from an equity option for taxpayers that are dealers in neither the underlying equity nor the equity options will generally be capital gain or loss. If the writer's obligation expires through the passage of time, the premium will constitute short-term capital gain to the writer upon such expiration.<sup>6</sup> If the writer sells the underlying stock pursuant to the exercise of a call option, the premium received by the writer increases the amount realized upon the sale of such stock in determining gain or loss. If the writer purchases the underlying stock pursuant to the exercise of a put option, the premium decreases the writer's basis in such stock. If the writer of a call or put option enters into a closing transaction by payment of an amount equivalent to the value of the call or put at the time of such payment, the difference between the amount so paid and the premium received is short-term capital gain or loss.<sup>7</sup>

There are special character and timing rules for option dealers, and these rules generally provide that income or loss from the options will be ordinary.<sup>8</sup> Furthermore, dealers are generally required to mark-to-market positions that are held at year-end. Option traders are able to make an election under Section 475(f) that would also alter the timing and character of option transactions. In general, if a trader makes a Section 475(f) election, positions held at year-end will be marked to market, and gains and losses will be ordinary rather than capital.

Special timing and character rules also apply to options that are part of a hedging transaction. With respect to the character of gain or loss on an acquired or written option that is identified as being part of a hedging transaction, the regulations provide that gain or loss on a short sale or option that is part of a hedging transaction is generally ordinary income or loss.<sup>9</sup> In addition, if a transaction is identified as a hedging transaction under Treas. Reg. Section 1.1221-2, the timing of gain and loss recognition will

be governed under Treas. Reg. Section 1.446-4, which generally requires the matching of the timing of gain and loss recognition under a hedge with the item being hedged.

Non-resident persons may be subject to withholding if they receive certain types of US-source income. An applicable income tax treaty may override the general rule. Source-based jurisdiction applies to fixed or determinable periodic amounts realized from US sources by non-resident foreign persons. Residence-based jurisdiction generally extends to citizens and residents, domestic corporations and foreign persons doing business in the United States. The tax imposed on a source basis is a 30 per cent withholding tax on US-source gross income.<sup>10</sup> In contrast, the tax applied to the worldwide income of citizens, residents and domestic corporations and to the income effectively connected with the US trade or business of non-resident foreign persons is a graduated-rate, self-assessed tax on net income.

There is substantial uncertainty as to the source of payments under option contracts. While Treasury is authorized to promulgate regulations governing the source of gain from the disposition of forward contracts, futures, options and other financial products,<sup>11</sup> no such regulations have been issued to date. Absent express statutory or regulatory guidance, general practice sources the gain on the disposition of an option contract according to the residence of the person receiving the gain.<sup>12</sup> Thus, capital gain income recognized by a foreign recipient would be foreign-source gain and, as a result, not subject to tax in the United States unless the foreign holder is engaged in a US trade or business. If gain is effectively connected with a US business or US real estate, a non-resident taxpayer will be subject to graduated tax rates under the residence-based sourcing rules.<sup>13</sup>

Income tax treaties affect US taxation of derivative financial instruments only in the limited situations in which a derivative produces US-source income for a foreign person. In those situations, however, an applicable tax treaty

5. Sec. 1234(b)(2)(A). "Property" includes "stocks and securities (including stocks and securities dealt with on a 'when issued' basis), commodities, and commodity futures." Sec. 1234(b)(2)(B).

6. Sec. 1234(b).

7. Sec. 1234(b)(1).

8. Sec. 1234(b)(3).

9. Treas. Reg. Sec. 1.1221-2.

10. Sec. 1441(a) provides that all persons having "control, receipt, custody, disposal, or payment of any items of income ... of any non-resident alien individual or any foreign partnership shall ... deduct and withhold from such items a tax equal to 30 per cent thereof." The term "income" under Sec. 1441(b) includes "interest ... dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income" (emphasis added). Sec. 1441(c) provides for exceptions, including income connected with US business. No deduction or withholding is required in the case of any item of income which is effectively connected with the conduct of a trade or business within the United States and which is included in gross income of the recipient.

11. Sec. 865(j)(2).

12. See *Tax Aspects of Derivative Financial Instruments*, 49th IFA Cong. Res. (Cannes 1995), at 2.3.

13. Note that a non-resident is not engaged in a US trade or business, upon recognizing gain, she or he may need to file certain forms with the Internal Revenue Service (hereinafter: IRS) in order to be exempt from withholding.



can provide considerable protection to residents of a treaty country who do not have a US permanent establishment.<sup>14</sup>

Thus, under general practice, if an option writer (that is not a dealer) is a non-resident, and recognizes income with respect to the expiration, exercise or sale of an option in the United States (which is not considered effectively connected income), the income should be characterized as foreign-source income and the writer would have no US tax liability. If the income were effectively connected income, the income would be subject to a graduated-rate, self-assessed tax on net income. However, this result is not free from doubt, and it is recommended that a taxpayer seek expert advice if a determination as to sourcing needs to be made.

## B. Tax treatment of holder

Premiums paid by an option holder are capitalizable, not deductible. The holder of an option generally recognizes gain or loss when it sells the option, terminates the option through offset or settlement, exercises a cash settlement option or allows the option to lapse. Gain or loss on a sale of an option or upon cash settlement of an option, generally equals the difference between the premium paid and the proceeds from the sale. If the option is exercised for property, the holder's exercise of an option will generally not be a taxable event; instead, the holder will add the premium to the cost of the property acquired by exercising the option. Specifically, if an equity call option is exercised, its cost is added to the basis of the stock purchased. If a put option is exercised, its cost reduces the amount realized upon the sale of the underlying stock in determining gain or loss. If the holder is either a dealer or trader or if the option is part of a hedging transaction, the timing of gain and loss recognition will be different, as discussed above.

In general, if an equity call or put option is sold prior to exercise, any gain or loss recognized by the holder who is not a dealer or an electing trader should be capital gain or loss. The gain or loss will be short-term or long-term in nature, depending upon the holding period of the call or put option. If the call or put is allowed to expire without exercise, the expiration is treated as a sale or exchange of the call or put on the expiration date. The resulting loss is a capital loss, and is short-term or long-term, depending on the holding period of the call or put.<sup>15</sup> If, however, the taxpayer is a dealer in either the underlying stock or the options themselves, gain or loss will be ordinary.

There are several tax rules that would suspend the holding period of an option, so as to limit an option holder from recognizing long-term capital gain income. The tax law provides for special treatment of straddles, which are defined as "offsetting positions in personal property".<sup>16</sup> Most particularly, a taxpayer may not take a loss on one of the positions in a straddle to the extent of unrealized gains in any other offsetting positions.<sup>17</sup> In such case:

- the taxpayer must capitalize all expenses associated with carrying positions that are part of a straddle;<sup>18</sup> and
- its holding period on any position that is part of a straddle does not begin to run until the position ceases to be part of the straddle.<sup>19</sup>

For these purposes, a taxpayer will be considered to hold "offsetting positions with respect to personal property" if holding one of the positions substantially diminishes the taxpayer's risk of loss from holding any other position.<sup>20</sup> There is no guidance in the context of the straddle rules as to the definition of "substantial diminution of risk of loss". Taxpayers have taken various positions in this area, but there is nothing authoritative providing a safe harbour or other measuring stick to determine when the taxpayer is in danger of becoming subject to the straddle rules.

"Personal property" is any property of a kind that is actively traded.<sup>21</sup> Stock is only included in the definition of personal property if the relevant offsetting position is an option with respect to that stock or substantially identical stock or a position with respect to "substantially similar or related property" other than stock.<sup>22</sup>

If (1) an option and other positions held by the holder constitute positions in a straddle and (2) the holder disposed of less than all the offsetting positions, any loss from the disposition is deferred to the extent of unrecognized gain remaining at the close of the year in:

- a successor position;
- an offsetting position to the loss position; or
- an offsetting position to any successor position.

A "successor position" means a position that is or was at any time, offsetting to a second position where (1) the second position was offsetting to any loss position disposed of and (2) the new position is entered into during the period commencing 30 days before and ending 30 days after the disposition of the loss disposition.<sup>23</sup>

With regard to the holding period of straddle positions, the general rule is that the holding period of any position that is part of a straddle does not begin earlier than the date the taxpayer no longer holds directly or indirectly (through a related person or a flow-through entity) an offsetting position with respect to that position.<sup>24</sup> This rule does not apply to a position held by a taxpayer for the long-term holding period (or longer) before a straddle that includes such position is established.<sup>25</sup>

Thus, if the option holder owns any offsetting positions with respect to an option, the holder's holding period with respect to the option is "tolled", until the time that she or he has disposed of the offsetting positions, and any gain recognized with respect to the option will be short-term capital gain income. If, however, the holder has held the

14. Sec. 988 provides that the source of income or loss from a Sec. 988 transaction is determined with reference to the residence of the taxpayer. A Sec. 988 transaction includes an option if the amount which the taxpayer is entitled to receive or required to pay by reason of the option is denominated in terms of non-functional currency.

15. Sec. 1234A.

16. Sec. 1092.

17. Sec. 1092(a)(1)(A).

18. Sec. 263(g).

19. Treas. Reg. Sec. 1.1092(b)-2T(a)(1).

20. Sec. 1092(c)(2).

21. Sec. 1092(d)(1).

22. Sec. 1092(d)(3)(B).

23. Treas. Reg. Secs. 1.1092-1T(a)(2), 1.1092(b)-5T(a) and (n).

24. Treas. Reg. Sec. 1.1092(b)-2T(a)(1).

25. Treas. Reg. Sec. 1.1092(b)-2T(a)(2).

offsetting positions for long-term capital gain holding period prior to the establishment of the straddle, any losses that are recognized will be long-term capital losses. If a taxpayer hedges only a portion of her or his portfolio, absent identification of the positions as straddle positions, the IRS could find a straddle with any offsetting positions it chooses, and can even claim that one position offsets more than one other position.<sup>26</sup>

Character differences can also result if the option holder is a dealer, the option holder is a trader that has made an election under Section 475(f) or the option is held as part of an identified hedging transaction. Under these circumstances, gains and losses will generally be ordinary and not capital.

As mentioned above, there is substantial uncertainty as to the proper methodology for sourcing gains and losses recognized under option contracts. General practice sources gain based on the residence of the recipient; however, there is no express statutory or regulatory authority to support this position. Under this rule, if an option holder is a non-resident and not a dealer, income recognized with respect to the expiration, exercise or sale of an option should be sourced in accordance with the residence of the holder. In this case, income should be foreign-source income and not subject to tax in the United States, unless the income is received in connection with a US trade or business.

### III. OPTIONS SUBJECT TO THE SECTION 1256 MARK-TO-MARKET REGIME

Section 1256 contracts are subject to a special mark-to-market system of income and loss recognition. Section 1256 requires a taxpayer to recognize gain or loss from a Section 1256 contract as from the last day of her or his taxable year, by treating such contract as if it were sold at a price equal to its fair market value as from such date. In addition, a special character rule applies to treat any gain or loss with respect to a Section 1256 contract as 60 per cent long-term capital gain or loss and 40 per cent as short-term capital gain or loss, regardless of the taxpayer's actual holding period with respect to the Section 1256 contract. Section 1256 contracts include "non-equity options" and any "dealer equity option". Excluded from Section 1256 treatment are foreign currency transactions that qualify as a "988 hedging transaction", "hedging transactions", and securities subject to dealer mark-to-market rules under Section 475(a).

A non-equity option is any "listed option" that is not an "equity option". A listed option is any option (other than a right to acquire stock from the issuer of the stock) that is traded on (or subject to the rules of) a qualified board or exchange.<sup>27</sup> An equity option is any option to buy or sell stock or any option the value of which is determined directly or indirectly by reference to any stock (or groups of stocks) or stock index, except for certain indexes where (1) there is a designation by the Commodity Futures Trading Commission (referred to as the CFTC) of a contract market for a contract based on such group of stocks or stock index (i.e. a broad-based index) or (2) the IRS determines that the option meets the legal requirements for such

a designation. For example, Standard and Poor's 500 Index (referred to as the S&P 500) is a broad-based index, as compared to the Dow Jones Utilities Average Index, which is a narrow-based index.<sup>28</sup>

Thus, for purposes of Section 1256, options that are traded in (or subject to the rules of) a qualified board or exchange, provide for cash-settlement, and are based on a stock index that has been characterized as a "broad-based" index, are likely to be Section 1256 contracts.<sup>29</sup>

A dealer equity option is, with respect to an "options dealer", any listed option that is:

- an equity option;
- purchased or granted by such options dealer in the normal course of her or his activity of dealing in options; and
- listed on the qualified board or exchange on which such options dealer is registered.

The mark-to-market rules of Section 1256 explicitly provide that, in general, gain or loss from trading Section 1256 contracts is characterized as capital gain or loss, rather than ordinary gain or loss. These rules do not apply to any Section 1256 contracts that are part of a hedging transaction if any loss connected with the transaction would be characterized as ordinary. The determination of whether gain or loss would be ordinary is made without regard to whether the taxpayer is actively engaged in dealing or trading Section 1256 contracts.

### IV. APPLICATION OF GENERAL TAX RULES TO PARTICULAR OPTIONS

#### A. Plain-vanilla index option

In general, under a plain-vanilla index option, the holder is entitled to receive a payment determined with reference to the difference in the value of a certain index, from the inception of the contract through the term of the contract. These options can be exercised only at expiration (European-style options), and these options can be structured as either call options or put options. The holder of a call option has a right to receive cash, based on the extent to which the index on the exercise date is above a pre-stated value. The writer of a call option has an obligation to pay cash in an amount determined the same way. A put option resembles a call option except that a holder's right to receive cash and a writer's obligation to pay cash are based

26. Priv. Ltr. Rul. 199925044 (3 February 1999). Note, however, that this position is based on guidance provided by a private letter ruling and, thus, is subject to recharacterization by the IRS.

27. A qualified board or exchange means "a national securities exchange which is registered with the Securities and Exchange Commission, a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, or any other exchange, board of trade, or other market which the Secretary determines has rules adequate to carry out the purposes of this section". Sec. 1256(g)(7).

28. *In The Matter Of The Applications Of The Chicago Board Of Trade For Contract Market Designation In The CBOT Dow Jones Utilities Average Index And CBOT Dow Jones Transportation Average Index Futures Contracts And Options On Those Futures Contracts*, Admin. Proc. File No. 3-9520 (16 July 1998) Release No. 34-40216, 67 SEC Docket 1204.

29. Rev. Rul. 94-63, 1994-2 CB 188.



on the extent to which the index on the exercise date is below a pre-stated value.

Assuming that neither counterparty is a dealer, the premium paid to enter into this option will not necessarily be includible in income (nor allowed as deduction) in the year it is paid. The premium will not be accounted for until the option is either exercised, lapses or is otherwise terminated. Upon the occurrence of any of these events, the option holder will generally recognize gain or loss equal to the amount received less the amount paid for the option (i.e. the premium). The option writer will have gain or loss equal to the amount of the option premium received less the cash settlement payment. If the options are Section 1256 contracts or the option holder is a dealer, gain or loss will generally be determined upon the earlier of (1) the holder's taxable year-end or (2) the lapse, exercise or termination of the option.

The timing of loss recognition can be affected by the existence of underlying assets/liabilities to which the option can be regarded as being related. If the option and an underlying asset/liability constitute a straddle within the meaning of Section 1092, the recognition of loss could be disallowed. If an investor believes that she or he may have a straddle, the investor should identify the positions as offsetting positions, as from the day that the straddle is established.<sup>30</sup> In addition, if the option is held as part of an identified hedging transaction, the timing of income and loss recognition may be altered so as to match the timing of the hedged property.

The character of any gain or loss recognized by an option holder will depend on whether these index options are Section 1256 contracts. If these options are exchange traded and based on a broad-based stock index, the options will likely be subject to the mark-to-market rules of Section 1256. As a result, the holder will have 60 per cent long-term and 40 per cent short-term capital gain or loss upon exercise, lapse or termination of the option, regardless of the holding period of the option. The option writer, however, will continue to have short-term capital gain or loss if the option writer is not a dealer. If the option writer is a dealer, she or he should have ordinary gain or loss.

If these options are non-Section 1256 contracts, the holder of the option will have long-term or short-term capital gain or loss, depending on the period that the holder held the option unhedged, and subject to the application of the straddle rules. The option writer will have short-term capital gain or loss, assuming that the writer is not a dealer.

As noted above, there is substantial uncertainty as to the proper sourcing of gains recognized with respect to options. While gain is generally sourced to the residence of the recipient, it is recommended that an investor seek expert advice in making the determination of how to source gains and losses. If the gain is attributable to a US trade or business, the income will be subject to tax in the United States.

## B. Asian index option and Asian-end index option

The holder of an Asian index option is entitled to receive a cash payment determined with reference to the percentage

difference between the value of a certain index at the inception of the option contract and the average of the value of the index over a certain period of time. An end-end index option is a combination of a plain-vanilla and Asian index option. In general, the option is tied to the value of the underlying index for a period of time, and then the values of the index are averaged for the remaining part of the contractual period.

Assuming that neither counterparty is a dealer, the premium paid to enter into either of these options will not necessarily be includible in income (nor allowed as a deduction) in the year it is paid. The premium will not be accounted for until either the option is exercised, lapses or is otherwise terminated. Upon the occurrence of any of these events, the option holder will generally recognize gain or loss equal to the amount received less the amount paid for the option (i.e. the premium). The option writer will have gain or loss equal to the amount of the option premium received less the cash settlement payment. If the options are Section 1256 contracts or if the option holder is a dealer, gain or loss will generally be determined upon the earlier of (1) the holder's taxable year-end or (2) the lapse, exercise or termination of the option.

The timing of loss recognition can be affected by the existence of underlying assets/liabilities to which the option can be regarded as being related. If the option and an underlying asset/liability constitute a straddle within the meaning of Section 1092, the recognition of loss could be disallowed. If an investor believes that she or he may have a straddle, that investor should identify the positions as offsetting positions, as from the day that the straddle is established.<sup>31</sup> In addition, if the option is held as part of an identified hedging transaction, the timing of income and loss recognition may be altered so as to match the timing of the hedged property.

The character of any gain or loss recognized by an option holder will depend on whether these index options are Section 1256 contracts. If these options are exchange traded and based on a broad-based stock index, the options will likely be subject to the mark-to-market rules of Section 1256. As a result, the holder will have 60 per cent long-term and 40 per cent short-term capital gain or loss upon exercise, lapse or termination of the option, regardless of the holding period of the option. The option writer, however, will continue to have short-term capital gain or loss if the option writer is not a dealer. If the option writer is a dealer, she or he should have ordinary gain or loss.

If these options are non-Section 1256 contracts, the holder of the option will have long-term or short-term capital gain or loss, depending on the period that the holder held the option unhedged, and subject to the application of the straddle rules. The option writer will have short-term capital gain or loss, assuming that the writer is not a dealer.

As noted above, there is substantial uncertainty as to the proper sourcing of gains recognized with respect to options. While gain is generally sourced to the residence of the recipient, it is recommended that an investor seek

30. Priv. Ltr. Rul. 199925044 (25 June 1999).

31. Id.

expert advice in making the determination of how to source gains and losses. If the gain is attributable to a US trade or business, the income will be subject to tax in the United States.

### C. Cliquet index option and multi-cliquet index option

At fixed dates over the term of a cliquet index option, the value of the index is assessed and compared with the out-set value of the same index. If the variation is positive, the percentage increase of the value of the index is taken into account in determining the pay-off of the contract. If the variation of the index is negative, the percentage decrease of the value of the index is not taken into account in determining the pay-off of the contract. As compared to a cliquet index option, a multi-cliquet index option uses more than one index as benchmarks under the contract. As a result, a negative variation in any of the underlying indexes is disregarded in determining the pay-off of the contract.

Assuming that neither counterparty is a dealer, the premium paid to enter into either of these options will not necessarily be includible (nor allowed as a deduction) in income tax in the year it is paid. The premium will not be accounted for until the option is either exercised, lapses or is otherwise terminated. Upon the occurrence of any of these events, the option holder will generally recognize gain or loss equal to the amount received less the amount paid for the option (i.e. the premium). The option writer will have gain or loss equal to the amount of the option premium received less the cash settlement payment. If the options are Section 1256 contracts or if the option holder is a dealer, gain or loss will generally be determined upon the earlier of (1) the holder's taxable year-end or (2) the lapse, exercise or termination of the option.

The timing of loss recognition can be affected by the existence of underlying assets/liabilities to which the option can be regarded as being related. If the option and an underlying asset/liability constitute a straddle within the meaning of Section 1092, the recognition of loss could be disallowed. If an investor believes that she or he may have a straddle, that investor should identify the positions as offsetting positions, as from the day that the straddle is established.<sup>32</sup> In addition, if the option is held as part of an identified hedging transaction, the timing of income and loss recognition may be altered so as to match the timing of the hedged property.

The character of any gain or loss recognized by an option holder will depend on whether these index options are Section 1256 contracts. If these options are exchange traded and based on a broad-based stock index, the options will likely be subject to the mark-to-market rules of Section 1256. As a result, the holder will have 60 per cent long-term and 40 per cent short-term capital gain or loss upon exercise, lapse or termination of the option, regardless of the holding period of the option. The option writer, however, will continue to have short-term capital gain or loss if the option writer is not a dealer. If the option writer is a dealer, she or he should have ordinary gain or loss.

If these options are non-Section 1256 contracts, the holder of the option will have long-term or short-term capital gain or loss, depending on the period that the holder held the option unhedged, and subject to the application of the straddle rules. The option writer will have short-term capital gain or loss, assuming that the writer is not a dealer.

As noted above, there is substantial uncertainty as to the proper sourcing of gains recognized with respect to options. While gain is generally sourced to the residence of the recipient, it is recommended that an investor seek expert advice in making the determination of how to source gains and losses. If the gain is attributable to a US trade or business, the income will be subject to tax in the United States.

### D. Look-back index option

Under a look-back index option, the highest value of the index over the contractual period is compared at the initial value in order to determine the percentage variation to be used in calculating the pay-off under the option contract.

Assuming that neither counterparty is a dealer, the premium paid to enter into this option will not necessarily be includible in income (nor allowed as a deduction) in the year it is paid. The premium will not be accounted for until the option is either exercised, lapses or is otherwise terminated. Upon the occurrence of any of these events, the option holder will generally recognize gain or loss equal to the amount received less the amount paid for the option (i.e. the premium). The option writer will have gain or loss equal to the amount of the option premium received less the cash settlement payment. If the options are Section 1256 contracts or the option holder is a dealer, gain or loss will generally be determined upon the earlier of (1) the holder's taxable year-end or (2) the lapse, exercise or termination of the option.

The timing of loss recognition can be affected by the existence of underlying assets/liabilities to which the option can be regarded as being related. If the option and an underlying asset/liability constitute a straddle within the meaning of Section 1092, the recognition of loss could be disallowed. If an investor believes that she or he may have a straddle, the investor should identify the positions as offsetting positions, as from the day that the straddle is established.<sup>33</sup> In addition, if the option is held as part of an identified hedging transaction, the timing of income and loss recognition may be altered so as to match the timing of the hedged property.

The character of any gain or loss recognized by an option holder will depend on whether these index options are Section 1256 contracts. If these options are exchange traded and based on a broad-based stock index, the options will likely be subject to the mark-to-market rules of Section 1256. As a result, the holder will have 60 per cent long-term and 40 per cent short-term capital gain or loss upon exercise, lapse or termination of the option, regardless of the holding period of the option. The option writer,

32. *Id.*

33. *Id.*