THE TAXATION OF INCOME FROM OPTION WRITING BY NONRESIDENTS

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OTA Paper 15 August 1976

Office of Tax Analysis
U.S. Treasury Department, Room 1104
Washington, D. C. 20220
Issued: May 1977

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I. INTRODUCTION

Legislation was introduced in early 1976 by Representative Mikva (D. Illinois) to close an unintended tax loophole involving the writing of call options. HR 12224, enacted as Act Sec. 2136(b) of the Tax Reform Act of 1976, reclassifies profits realized by writers upon the repurchase or lapse of their options from ordinary income to short-term capital gains. In so doing, it eliminates the loophole previously enjoyed by some domestic investors, and produces an estimated revenue gain of $10 million.

However, HR 12224 also effectively exempts option premium income paid to nonresidents from U.S. taxation, at an estimated loss of $50 million (by comparison with what would be collected if such income were subject to U.S. tax). During the initial consideration of HR 12224 by the Ways and Means Committee, the belief was expressed that there was uncertainty regarding whether or not option writing income paid to nonresidents was subject to tax in the U.S. It was also suggested that it would be administratively impossible to implement a withholding tax on option premium income paid to nonresidents. In my view, neither of these contentions is entirely valid. Based on an examination of the characteristics of option premium income, it seems clear that the 30 percent withholding tax imposed under sections 871 and 881 of the Internal Revenue Code should apply.

Further, the Office of International Operations of the IRS has indicated in writing that the 30 percent tax should be withheld. While the administrative aspects of this matter are complex, they are not insurmountable. The following presentation indicates: (1) the basis for assessment of tax at source on option premium income; (2) the modifications to HR 12224 which would be necessary to preserve the short-term capital gain treatment of this type of income when paid to domestic investors while retaining the right to withhold tax at source when paid to nonresidents; (3) the most promising means for implementation of a withholding tax; and (4) a brief explanation of the $50 million revenue estimate.

II. BASIS OF TAXABILITY

To justify the implementation of a U.S. withholding tax on option premium income paid to nonresidents, it must be shown that such premiums fall within the category of income subject to the nonresident withholding tax, and that the premium income is attributable to U.S. sources.

The relevant sections of the Internal Revenue Code, sections 871, 881, and 1441, specify that "premiums" are to be included among the various types of income subject to the nonresident withholding tax. For example, section 871 reads:

> "There is hereby imposed for each taxable year a tax of 30 percent of the amount received from sources within the United States by a nonresident alien individual as--
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> (A) interest (other than original issue discount as defined in section 1232(b)), dividends, rents, salaries wages, premiums, annuities, compensation, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income,..."

While it could be argued that the authors of these provisions did not specifically intend option premiums to be covered by this definition, income from option writing is in fact commonly termed "premium income". The use of the word "premium" to describe income paid to option writers stems not simply from an arbitrary convention adopted by the investment community. Rather, the nature of options is in many ways similar to that of insurance policies, and payments to insurance underwriters have historically been referred to as "premiums". The holder of an option in effect purchases insurance which guarantees that within a specified time period he will be able to acquire a certain security at a set price, regardless of how great the rise in the market value of the security may be. The United States has a longstanding position of taxing insurance premiums paid to nonresidents. Section 4371 imposes a tax on various types of insurance, indemnity bonds, annuity contracts and reinsurance policies. While this levy has technically been classified as an excise tax, it has always been treated with income taxes for treaty purposes, and is in fact based on gross premium income paid to foreign insurers. Thus, to the extent that call options resemble insurance contracts, there is a clear precedent for the imposition of a tax at source based on the amount of gross income being paid.

Regulation 1.1441-2(a), defining the phrase "fixed or determinable annual or periodical income," also points to the conclusion that option writing income is subject to withholding:

> "Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. The income need not be paid annually if it is paid periodically; that is to say, from time to time, whether or not at regular intervals."

Option premium income is determinable: at the time of exercise, expiration, or repurchase, the definite amount of the writer's gain or loss may be calculated. It is also periodical, in that it is paid "from time to time", even though not at regular intervals. Revenue Ruling 58-479, 1958-2 C.B.60, clarified that income is "fixed or determinable annual or periodical" even if it is paid in one lump sum at one time with no expectation that any related payments will subsequently be made. The particular case established the taxability of a prize awarded by an art institute to a nonresident artist. Such a payment would not be determinable at the time the work of art was created or even at the time it was entered in the competition, paralleling the uncertainty regarding the income an option writer will eventually receive. Only at the end of the venture, after the judging, could the amount of the prize income be determined; similarly, only upon exercise, expiration, or repurchase can option premium income be determined. Further "periodical" payments to the artist would only result if additional works were entered in subsequent competitions, again paralleling the situation with respect to option writers, who continue to receive income periodically only if additional options are written.

It might be advanced that option premium income is analogous to payments received upon the disposition of personal property, which, under existing law, are not subject to U.S. taxation when paid to nonresidents. The thrust of this argument is based on the contention that options, like other securities, fall within the category of assets known as personal property. However, the writer of an option does not transfer any asset, personal property or otherwise, at the time of the sale of the option. Instead, the writer agrees to render the service of delivering a security at a specified price at some future time, upon instruction from the party to whom the option was sold. Prior to the passage of HR 12224, all pertinent legal doctrines provided that option premium income could not be categorized as income resulting from the disposition of personal property.[1/] Thus, profits which a writer realizes could be categorized more accurately as personal service income or insurance premiums than as proceeds from the disposition of personal property. And while there is some validity to the analogy between writing an option contract and performing a personal service, without exception the U.S. taxation authorities have categorized option premiums as investment income, rather than earned income. Therefore, the procedures which have been implemented to tax earned income derived from

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1/ For example, Revenue Ruling 63-183, 1963-2 C.B. 285, and the Chicago Board Options Exchange Ruling, 9 CCH Std. Fed Tax Rptr. §4739.201 (1974), state that the income realized in the closing transaction is not considered attributable to a sale or exchange.

U.S. sources by nonresidents are not apposite to this rather unique form of investment-personal service income.

In order to impose a tax on option premium income, it must be clearly established that such income is derived from sources within the United States. From a technical standpoint, option premium income is always paid from a U.S. source, regardless of the domicile of the holder, since writers directly sell their options to and receive their premiums from the Options Clearing Corporation, a U.S. entity. (The Clearing Corporation, in turn, issues an identical security to the holder so that its asset (acquired from the writer) offsets the liability (issued to the holder).)

In conclusion, the most cogent justification for a U.S. source rule is the analogy between option writing income and insurance premiums. The role of the writer of call options is very much the role of an insurer. The writer guarantees to the holder that he will not suffer financial loss as a result of an increase in the market price of a security prior to his acquisition of that security, in exchange for a predetermined premium. Whenever foreign entities derive insurance premiums from within the U.S., such income is deemed attributable to sources within the United States. Similarly, when insurance coverage is provided through the vehicle of a call option, the income remitted to the nonresident insurer in compensation for such services should be deemed attributable to sources within the United States.

Section 863 authorizes the Secretary of the Treasury or his delegate to prescribe regulations specifying the determination of source for items of income not enumerated in sections 861(a) or 862(a). As option premium income is not referred to in either of those sections, the way is clear for Regulations to be promulgated providing for the attribution of option income to sources within the United States.

III. MODIFICATION OF H.R. 12224

HR 12224 characterizes option writing income as short-term capital gain (or loss), regardless of the period for which the option is written and regardless of whether or not the option is exercised. The sole exception is in cases where the security underlying an option which is exercised has been held by the writer for a period of time longer than six months, in which case long-term capital gain (or loss) results. The characterization provided by HR 12224 ensures that U.S. residents cannot offset option writing losses against ordinary income. However, this domestic loophole could be closed in another way, without exempting option income paid to nonresidents from U.S. taxation.

Under the alternative approach, the classification of profits from option writing could be changed back to ordinary income, as it was before the inclusion of HR 12224 in the Tax Reform Act of 1976, but option-derived ordinary losses would only be deductible against option-derived ordinary income, and against capital gains (whether or not option-derived). Further, capital losses incurred in option investments would be deductible against ordinary option-derived income, as well as capital gains. Excess option-derived ordinary losses would be includible in the $1,000 per year deduction against ordinary income provided by section 1211(b), and could be carried forward indefinitely--the same as short-term capital losses.

This alternative treatment would have the following effect in the three examples of option investments presented in the Committee Report on HR 12224 (94-1192):

Example 1.

> Writing a covered out-of-the-money option. Suppose Ford Motor Company stock is selling for 57-1/4 (as it was on April 2, 1976) and someone writes a call for 100 shares at 60 expiring October 16. On April 2 this option sold at a premium of 4. Assume the writer also buys 100 shares of Ford stock at 57-1/4.

If the market price of the stock rises, the loss on the option would remain ordinary loss, but would only be deductible against the full amount of the gain on the underlying security. For example, if the price of Ford increased to 70, the gain on the stock (long-term capital gain) would be 12-3/4. The loss on the option would be 6. (10 repurchase cost less 4 premium.) This would be deductible from the full 12-3/4, for a net capital gain of 6-3/4 (3-3/8 if long-term), the correct taxable amount if it is accepted that the actual amount of economic gain should be the basis for taxation.

If the value of Ford declined to 50, the capital loss on the stock would be 7-1/4, while the ordinary income gain from the option premium would be 4. The amount of the capital loss would be allowed to offset the ordinary income so that net capital loss would be 3-1/4 (7-1/4 - 4), (1-5/8 if long term), which could be used to offset other option derived income or capital gains in the same taxation year, or carried forward.

Example 2.

> Writing covered in-the-money options. Assume that on April 2, 1976, an individual buys 100 shares of Ford at 57-1/4 and writes a call option for 100 shares of Ford with an October 16 expiration date and a striking price of 45. This option sold for a premium of 12-3/4 on April 2.

If the market price for Ford stock rises to 70, the capital gain is 12-3/4, while the ordinary premium loss is 12-1/4 (25 repurchase cost less 12-3/4 premium), which when deducted from the capital gain leaves the correct amount, 1/2, as taxable income.

With a price decline to 50, capital gain on the stock is 1/2, if delivered upon exercise at 45.

If the price of Ford falls to 40, the loss on the stock is 17-1/4, while the premium income is 12-3/4. The loss would be allowed to offset the premium, leaving 4-1/2 (2-1/4 if long term) as excess capital loss.

Example 3.

> Option spreads. A "spread" consists of writing one option and buying another option on the same underlying stock. Suppose someone writes a call option on April 2, 1976, to buy 100 shares of Ford stock at 45 for a premium of 12-3/4 and on the same date buys an option to buy 100 shares of Ford at 50 for a premium of 9-1/2. Both options have expiration dates of October 16, and the price of Ford stock was 57-1/4 on April 2.

If the price of the underlying stock increases to 70, ordinary loss on the 45 is 12-1/4, (25 - 12-3/4); while capital gain on the 50 is 10-1/2, (20 - 9-1/2). The ordinary loss completely offsets the capital gain, and a 1-3/4 point loss remains to offset other capital gains or option-derived income, for inclusion in the section 1211 $1,000 allowance, or to be carried forward.

If the value of Ford falls to 40, the loss on the 50 is 9-1/2 (capital), while the gain on the 45 is 12-3/4 (ordinary). The 9-1/2 point loss partially offsets the ordinary gain, leaving net taxable ordinary income of 3-1/4 points, which is the actual amount of economic gain.

Essentially, the proposed modifications would leave the tax treatment of option income for domestic investors the same as proposed by HR 12224, but without classifying the income as short-term capital gain. This modification would retain the taxable status of option writing income when it is paid to nonresidents. In order to avoid possible confusion, section 861 might also be amended to state that premium income realized from the writing of options in the U.S. by nonresidents is allocable to sources within the United States. Alternately, this could be accomplished by the issuance of a Regulation, pursuant to section 863.

IV. WITHHOLDING TAX ON NONRESIDENTS

The most administratively simple procedure for implementation of a tax on option premium income paid to nonresidents would be to impose a withholding tax on gross premium payments. Accepted accounting definitions recognize the realization of income from option writing only upon repurchase, exercise, or expiration. Therefore, a withholding tax on gross payments would be imposed not on income, but on gross receipts. Accordingly, the rate of the tax should be reduced from the customary 30 percent in order to reflect the fact that the basis upon which it is applied considerably exceeds the customary definition of option writing income. Since it is estimated that the ratio of gross premiums to net income is of the order of 2.6:1, an appropriate rate for the withholding tax would be approximately 10 percent. On average, a 10 percent tax on gross receipts would represent approximately the same level of taxation as a 30 percent tax levied on income realized at the close of the transaction.

Many option writers will realize losses on their transactions. They might be required to deliver an underlying security at less than its market value, or they might repurchase the option for a premium greater than that received at the time of writing. Therefore, it seems appropriate to permit a "net income election" for option writing income paid to nonresidents, paralleling the election provided for by sections 871(d) and 882(d) for real estate income. In other words, a 10 percent withholding tax would be applied to gross premiums, but nonresidents would be permitted a net income election. One provision of the section 871(d) alternative net income computation is the requirement that once the election has been made, it may not be revoked except with the consent of the Secretary or his delegate. Since the objective of a net income election is to offer more equitable--not necessarily more favorable--tax treatment to nonresident investors, the extension of this "lock-in" feature to the option net income election may be appropriate. It is difficult to determine the precise revenue impact of the net income election. However, by including a "lock-in" provision, its use would be confined to those for whom the withholding tax would otherwise create an unfair burden.

Since any profits resulting from an option which is exercised are classified as capital gains, adherence to the same principles which require the withholding of tax from ordinary income calls for the exemption from tax of all profits realized upon exercise of an option. Consistency is one of the primary thrusts of this proposal for a revision of tax policy regarding option income paid to nonresidents. Since all gains and losses accruing to domestic investors upon the exercise of outstanding options are classified as capital gains (long- or short-term depending on the duration of the holding period for the underlying security), the same treatment must be afforded nonresident option writers. It is well settled that capital gains realized by nonresidents are not subject to U.S. taxation: although section 861(a) attributes gains resulting from the disposition of securities within the United States to U.S. sources, Regulation 1.1441-2(a)~~(3)~~ specifies that the proceeds of such sales do not constitute "fixed or determinable annual or periodical income", and hence, that such income is exempt from the withholding tax. While this will in fact lead to the realization of some income free of tax, its effect on revenues will be minimal, since only a small percentage of all options written are ever exercised. The brokerage commissions incurred in exercising an option far exceed the transaction cost of realizing the same amount of gross profit through the secondary market. Therefore, options are usually only exercised in specialized cases, to wit: a holder whose primary purpose in purchasing the options is to acquire a substantial holding of the underlying security without bringing about unfavorable upward price movements, or a covered writer wishing to dispose of a large holding of the underlying security. If profits realized upon exercise were to be included in taxable income, losses arising from exercise would presumably have to be allowed as deductions, under the net income election. Therefore, exclusion from the tax base of gains and losses realized upon exercise should have only a negligible overall impact on the revenue estimate. The imposition of withholding tax on gross option writing premiums would not represent the first time tax was withheld from a payment other than net income. According to Revenue Ruling 72-87, 1972-1 C.B. 274, the full amount of a distribution which is partly attributable to earnings and profits and partly attributable to the disposition of capital assets is subject to withholding tax pending the determination of the proportion exempt as proceeds of sale or exchange, at which time a claim for partial refund is permitted. Even with interest or dividends, deductions for such necessary expenses directly prerequisite to the production of income as brokerage commissions and safe-keeping fees are not allowed. The justification for the reduction in the rate of withholding tax is that while the difference between gross and net income may be relatively small for most other types of payments subject to the tax, viz. interest and dividends, it is quite substantial in the case of option premium income. It would be unjust to impose a 30 percent tax on gross payments. By combining the lower-rate withholding tax with a net income election, administrative expenses can be held at an acceptable level, without the sacrifice of basic equity considerations.

In order to minimize administrative expenses, the optimal method of implementation of a nonresident withholding tax should allocate as many of the collection procedures as possible to the brokerage firms, rather than to the Internal Revenue Service. The Office of International Operations of IRS has expressed the opinion that the present wording of section 1441 of the Code may be interpreted as requiring, in this instance, that the brokers assume liability for collection of the tax.

An alternative proposal for implementation of a tax on option premium income paid to nonresidests calls for calculation by the brokers of net income arising from each option written, at the time of exercise, repurchase, or expiration of the option, and the withholding of 30 percent from this net income figure as tax. This is to say that tax would not be assessed until a closing transaction (or expiration) has taken place, and the net amount of income becomes determinable. Concededly, the brokerage industry would find this solution more complex than a 10 percent tax on gross receipts; but the nonresident investors might perceive this plan more favorably, in view of its decided equity advantages. Specifically, the security underlying a covered option and the margin deposited with the broker with respect to a naked option might be held as collateral to assure payment of tax liability upon realization of income (that is, upon expiration or repurchase). Due to the volatile nature of the call option market, substantial margin requirements have been adopted by the brokers for accounts engaging in option writing. The Options Clearing Corporation <u>Prospectus</u> states:

> "Brokers generally require Options writers to enter into margin agreements which give the broker a lien on securities and other assets held in the margin account."

I am proposing that these arrangements, which were designed to assure that securities could be delivered to meet the exercise of outstanding options, be extended to assure payment of tax liability upon termination of the option through repurchase or expiration. In the case of naked writing, the amount of the tax liability would be withheld from the margin, with the balance being returned to the investor. In the case of covered writing, the investor would normally be given the opportunity of remitting the appropriate amount of tax in cash to the broker. However, if he failed to do so, the broker would have control of the underlying security, and would be able to dispose of the security in the market in order to obtain the funds necessary to fulfill the investor's tax liability. Any excess proceeds from the disposition of the underlying security would of course be remitted to the investor.

By withholding tax from the option writer's margin or underlying security, more equitable treatment can be afforded to the foreign investor with respect to option spreads. If a withholding tax is deducted directly from the gross premiums received, cash flow problems could result, as the number of spreads per given capital expenditure is decreased. This reduction in the rate of return drastically discriminates against the foreign investor. However, under the "net income withholding" proposal, neutrality between domestic and foreign investors is maintained.

V. INTERNATIONAL IMPLICATIONS OF THE U.S. WITHHOLDING TAX

Securities exchanges abroad might begin offering options identical to those traded in the U.S. in response to the implementation of a withholding tax. In the past, the exchanges have been reluctant to trade in options already offered on another exchange, but a U.S. withholding tax might be a sufficient impetus to overcome these inhibitions. However, since the U.S. withholding taxes are generally creditable against foreign income taxes, the implementation of the tax in the U.S. should not, in itself, create a major incentive for the development of foreign option markets. In the unlikely event that the possibility of foreign competition did materialize to the detriment of the existing U.S. option exchanges, the rate of the withholding tax could always be reduced by action of Congress, to a level sufficiently low as to preclude the profitable operation of the foreign exchanges. The creation of competing foreign markets would have a negative impact on revenues, but the potential extent of that effect is impossible to estimate. Given the improbability that such developments will take place in the foreseeable future, any modification of the revenue estimate does not appear to be justified.

VI. REVENUE ESTIMATE

A procedure has been developed to estimate the revenue which would result from the implementation of a withholding tax on option premium income paid to nonresidents. First, the annual opening sales volume was determined -- this figure reflects only sales of options by their initial writers, and excludes resales by option holders. Next, random sampling was used to estimate the average price of an option. Multiplying these two figures gives the aggregate value of opening option sales for one year. By comparing foreign option commissions with domestic option commissions for several major brokerage firms, the proportion of nonresident participation in U.S. option markets was determined. Taking this percentage of the figure obtained in the previous step indicates the gross amount of premiums paid to nonresident option writers. Based on data compiled to date, this figure is $436 million.

In order to determine net income, the Merrill Lynch projection of a 15 percent return on underlying capital was scaled down to 10 percent and was applied to the New York Stock Exchange Composite Index of stock prices, which was $55.57 on July 2, 1976, to give an expected annual income from covered option writing of $5.56 per share. Since each option exists for an average of 4-1/2 months, 2-2/3 options on each share would have to be written each year to yield an income of \$5.56 so that average net income per option would be \$2.085. Multiplying this value by the estimated number of nonresident opening option sales indicates an aggregate net income figure of \$169 million. Tax assessed at the rate of 30 percent on this amount would yield about \$50 million per year in revenue. Approximately the same revenue figure would result from the taxation of gross premiums at the rate of 10 percent (see Tables 1 and 2).

In view of the widely-held expectation that option trading volume will increase in the future, it seems probable that actual tax collections may reach even higher levels. Total U.S. tax withheld from income paid to nonresidents during the year 1972 amounted to over \$217 million. Collection of \$50 million from withholding on option premiums would increase that figure by 23 percent. While investment in call options may be somewhat less salient than investment in stocks and bonds, the revenues that can accrue from the taxation of option premium income paid to nonresidents is far from negligible. Implementation of the tax according to the procedures outlined herein will result in both equity for the investor, and a substantial increase in nonresident tax revenues for the Treasury.

Table 1: Gross Income Derivation

Annual Opening Sales	1,195 million options
Average Option Price	$5.38
Opening Sale Value	$6,431 million
Nonresident Participation	6.78 percent
Nonresident Opening Sale Value	$436 million

Table 2: Net Income Derivation

Annual Opening Sales	1,195 million options
Nonresident Participation	6.78 percent
Nonresident Opening Sale Volume	81 million
Profit per Option	$2.09
Nonresident Net Income	$169 million
Tax Revenue (at 30%)	$50 million