

sold. Assets acquired for arbitrage operations include only stocks and securities and rights to acquire stocks and securities. The property purchased may be either identical to the property sold or, if not so identical, such that its acquisition will entitle the taxpayer to acquire property which is so identical. Thus, the purchase of bonds or preferred stock convertible, at the holder's option, into common stock and the short sale of the common stock which may be acquired therefor, or the purchase of stock rights and the short sale of the stock to be acquired on the exercise of such rights, may qualify as arbitrage operations. A transaction will qualify as an arbitrage operation under section 1233(f) only if the taxpayer properly identifies the transaction as an arbitrage operation on his records as soon as he is able to do so. Such identification must ordinarily be entered in the taxpayer's records on the day of the transaction. Property acquired in a transaction properly identified as part of an arbitrage operation is the only property which will be deemed acquired for an arbitrage operation. The provisions of section 1233(f) and this paragraph shall continue to apply to property acquired in a transaction properly identified as an arbitrage operation although, because of subsequent events, e.g., a change in the value of bonds so acquired or of stock into which such bonds may be converted, the taxpayer sells such property outright rather than using it to complete the arbitrage operation.

(4) *Effective date of section 1233(f)*. Section 1233(f), relating to arbitrage operations involving short sales of property, is effective only with respect to taxable years ending after August 12, 1955, and only with respect to short sales made after such date.

[T.D. 6500, 25 FR 12011, Nov. 26, 1960, as amended by T.D. 6494, 25 FR 9372, Sept. 30, 1960; T.D. 6926, 32 FR 11468, Aug. 9, 1967; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

#### § 1.1233-2 Hedging transactions.

The character of gain or loss on a short sale that is (or is identified as being) part of a hedging transaction is determined under the rules of § 1.1221-2.

[T.D. 8555, 59 FR 36367, July 18, 1994]

#### § 1.1234-1 Options to buy or sell.

(a) *Sale or exchange*—(1) *Capital assets*. Gain or loss from the sale or exchange of an option (or privilege) to buy or sell property which is (or if acquired would be) a capital asset in the hands of the taxpayer holding the option is considered as gain or loss from the sale or exchange of a capital asset (unless, under the provisions of subparagraph (2) of this paragraph, the gain or loss is subject to the provisions of section 1231). The period for which the taxpayer has held the option determines whether the capital gain or loss is short-term or long-term.

(2) *Section 1231 transactions*. Gain or loss from the sale or exchange of an option to buy or sell property is considered a gain or loss subject to the provisions of section 1231 if, had the sale or exchange been of the property subject to the option, held by the taxpayer for the length of time he held the option, the sale or exchange would have been subject to the provisions of section 1231.

(3) *Other property*. Gain or loss from the sale or exchange of an option to buy or sell property which is not (or if acquired would not be) a capital asset in the hands of the taxpayer holding the option is considered ordinary income or loss (unless under the provisions of subparagraph (2) of this paragraph, the gain or loss is subject to the provisions of section 1231).

(b) *Failure to exercise option*. If the holder of an option to buy or sell property incurs a loss on failure to exercise the option, the option is deemed to have been sold or exchanged on the date that it expired. Any such loss to the holder of an option is treated under the general rule provided in paragraph (a) of this section. In general, any gain to the grantor of an option arising from the failure of the holder to exercise it, and any gain or loss realized by the grantor of an option as a result of a closing transaction, such as repurchasing the option from the holder, is considered ordinary income or loss. However, for the treatment of gain or loss from a closing transaction with respect to or gain on the lapse of an option granted in stock, securities, commodities or commodity futures, see

section 1234(b) and § 1.1234-3. For special rules for grantors of straddles applicable to certain options granted on or before September 1, 1976, see § 1.1234-2.

(c) *Certain options to sell property at a fixed price.* Section 1234 does not apply to a loss on the failure to exercise an option to sell property at a fixed price which is acquired on the same day on which the property identified as intended to be used in exercising the option is acquired. Such a loss is not recognized, but the cost of the option is added to the basis of the property with which it is identified. See section 1233(c) and the regulations thereunder.

(d) *Dealers in options to buy or sell.* Any gain or loss realized by a dealer in options from the sale or exchange or an option to buy or sell property is considered ordinary income or loss under paragraph (a)(3) of this section. A dealer in options to buy or sell property is considered a dealer in the property subject to the option.

(e) *Other exceptions.* Section 1234 does not apply to gain resulting from the sale or exchange of an option:

(1) To the extent that the gain is in the nature of compensation (see sections 61 and 421, and the regulations thereunder, relating to employee stock options);

(2) If the option is treated as section 306 stock (see section 306 and the regulations thereunder, relating to dispositions of certain stock); or

(3) To the extent that the gain is a distribution of earnings or profits taxable as a dividend (see section 301 and the regulations thereunder, relating to distributions of property).

(4) Acquired by the taxpayer before March 1, 1954, if in the hands of the taxpayer such option is a capital asset (whether or not the property to which the option relates is, or would be if acquired by the taxpayer, a capital asset in the hands of the taxpayer).

(f) *Limitations on effect of section.* Losses to which section 1234 applies are subject to the limitations on losses under sections 165(c) and 1211 when applicable. Section 1234 does not permit the deduction of any loss which is disallowed under any other provision of law. In addition, section 1234 does not apply to an option to lease property,

but does apply to an option to buy or sell a lease. Thus, an option to obtain all the right, title, and interest of a lessee in leased property is subject to the provisions of section 1234, but an option to obtain a sublease from the lessee is not. Furthermore, if section 1234 applies to an option to buy or sell a lease, it is the character the lease itself, if acquired, would have in the hands of the taxpayer, and not the character of the property leased, which determines the treatment of gain or loss experienced by the taxpayer with respect to such an option.

(g) *Examples.* The rules set forth in this section may be illustrated by the following examples:

*Example 1.* A taxpayer is considering buying a new house for his residence and acquires an option to buy a certain house at a fixed price. Although the property goes up in value, the taxpayer decides he does not want the house for his residence and sells the option for more than he paid for it. The gain which taxpayer realized is a capital gain since the property, if acquired, would have been a capital asset in his hands.

*Example 2.* Assume the same facts as in example (1), except that the property goes down in value, and the taxpayer decides not to purchase the house. He sells the option at a loss. While this is a capital loss under section 1234, it is not a deductible loss because of the provisions of section 165(c).

*Example 3.* A dealer in industrial property acquires an option to buy an industrial site and fails to exercise the option. The loss is an ordinary loss since he would have held the property for sale to customers in the ordinary course of his trade or business if he had acquired it.

[T.D. 6500, 25 FR 12013, Nov. 26, 1960, as amended by T.D. 7652, 44 FR 62282, Oct. 30, 1979]

**§ 1.1234-2 Special rule for grantors of straddles applicable to certain options granted on or before September 1, 1976.**

(a) *In general.* Section 1234(c)(1) provides a special rule applicable in the case of gain on the lapse of an option granted by the taxpayer as part of a straddle. In such a case, the gain shall be deemed to be gain from the sale or exchange of a capital asset held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) on the day that the option expired. Thus,