

# ISDA

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May 19, 2004

Honorable Charles Grassley  
Chairman  
Committee on Finance  
United States Senate  
Washington, D.C. 20510

Honorable Max Baucus  
Ranking Member  
Committee on Finance  
United States Senate  
Washington, D.C. 20510

Re: S. 1637 (Qualified Covered Calls)

Dear Chairman Grassley and Senator Baucus:

While we support the basic provisions of S. 1637 to create jobs and simplify our complex international tax laws, we are particularly concerned with one provision of legislation which is wholly unrelated to these important objectives; namely, the proposal to deny “qualified covered call” (“QCC”) treatment to over-the-counter (“OTC”) options while maintaining that treatment for listed (exchange-traded) options.

By way of background, and as described more fully in the enclosed paper, covered call writing is an investment strategy whereby an investor seeks to enhance the cash yield on his or her stocks by selling call options on such stocks and receiving premiums for such options. Covered call writing is not a tax-advantageous strategy, because the premiums received on the sold call options are taxed at ordinary income rates (when the options lapse unexercised). Congress acknowledged that covered call writing should not be subject to the adverse tax treatment of the straddle rules by enacting the QCC exception to the straddle rules in 1984.

In light of the importance of the QCC exception for covered call writing, we strongly oppose the proposal to repeal QCC treatment only for OTC options while retaining such treatment for listed options for several reasons. First, we believe it is not sound tax policy to provide favorable QCC tax treatment to listed options, including “flex options” that are economically similar to OTC options, while denying that same treatment to OTC options. Such a disparity is unfair by violating the fundamental principle of taxing economically comparable transactions in a consistent manner. OTC options are competitive

alternatives to listed options — particularly flex options — so taking away QCC treatment for OTC options will reduce both competition and investor choice in the options markets.

Second, Treasury and the IRS fully analyzed the policy issues underlying QCC treatment for OTC options during an extensive period of proposing regulations and considering taxpayer comments, resulting in the issuance in 2002 of the current regulations that extend QCC treatment to OTC options subject to appropriate restrictions.

Finally, in addition to the policy merits of maintaining QCC treatment for OTC options, we do not believe that the proposed QCC amendment in S. 1637 will raise any significant revenues.

For these reasons, we urge you to reconsider the inclusion of this provision in the final legislation and thus preserve the current law QCC treatment for OTC options as well as listed options.

Thank you for taking the time to consider our request. We sincerely welcome the opportunity to discuss any of the points raised in our letter or in the enclosed paper. If you have any questions, or if we can assist you further in your consideration of our request, please feel free to contact me at 202-756-2980 or Thomas Prevost, Chair of ISDA's North American Tax Committee at 212-325-7486.

Very truly yours,



John Anderson  
Policy Director and Head of Government Affairs

Enclosure

cc: Edgar McClellan, Tax Counsel - Committee on Finance, U.S. Senate  
Patrick Heck, Minority Chief Tax Counsel - Committee on Finance, U.S. Senate  
Greg Nickerson, Tax Counsel - Committee on Ways and Means, U.S. House of Representatives  
John Buckley, Minority Chief Tax Counsel - Committee on Ways and Means, U.S. House of Representatives  
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