

The original documents are located in Box 54, folder “9/3/76 HR3052 Extension of 1976 Tax Withholding Rates and Tax Treatment of Options to Buy or Sell Securities” of the White House Records Office: Legislation Case Files at the Gerald R. Ford Presidential Library

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Bob Linder -

Dave Gergen told me this morning
that he was discussing the possibility of doing
a statement on this bill.

Trudy 9/3/76

APPROVED
SEP 3 - 1976

89/3/76

THE WHITE HOUSE
WASHINGTON
September 2, 1976

ACTION

Last Day: September 13

MEMORANDUM FOR

THE PRESIDENT

FROM:

JIM CANNON *J. Cannon*

SUBJECT:

H.R. 3052 - Extension of 1976 tax withholding rates and tax treatment of options to buy or sell securities

Attached for your consideration is H.R. 3052, sponsored by Representative Rostenkowski.

The enrolled bill would continue until September 15, 1976, the individual tax withholding rates and related individual and corporate estimated tax provisions which expired on September 1, 1976. The bill would also exclude from the unrelated business income tax income which an exempt organization receives in cases where an option to buy or sell securities is allowed to lapse or is terminated.

Additional information is provided in OMB's enrolled bill report at Tab A.

OMB, Max Friedersdorf, Counsel's Office (Lazarus) Bill Seidman and I recommend approval of the enrolled bill.

RECOMMENDATION

That you sign H.R. 3052 at Tab B.



Statement issued - 9/6/76

listed 9/3/76
archives 9/3/76



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

SEP 2 1976

MEMORANDUM FOR THE PRESIDENT

Subject: Enrolled Bill H.R. 3052 - Extension of 1976 tax
withholding rates and tax treatment of options
to buy or sell securities
Sponsor - Rep. Rostenkowski (D) Illinois

Last Day for Action

September 13, 1976 - Monday
Recommend action as soon as possible

Purpose

To extend to September 15, 1976, certain provisions of the Tax Reduction Act of 1975 and to exclude from the unrelated business income tax income which an exempt organization receives in cases where an option to buy or sell securities is allowed to lapse or is terminated.

Agency Recommendations

Office of Management and Budget

Approval

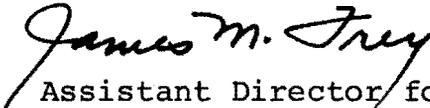
Department of the Treasury

Approval (Informally)

Discussion

H.R. 3052 would continue until September 15, 1976, the individual income tax withholding rates and related individual and corporate estimated tax provisions which expired on September 1, 1976. The extension of these rates and related provisions is required because Congress has failed to complete action on the Tax Reform Act (H.R. 10612), now in conference. In the absence of this extension, individual withholding rates would return to the higher levels in effect prior to the enactment of the 1975 Tax Reduction Act.

The enrolled bill would also make a change in the application of the unrelated business income tax to income which a tax exempt organization receives from writing options to buy or sell securities in cases where the option is allowed to lapse or is terminated. Under current law, premiums received by these organizations for options which are "exercised" are treated as capital gains and are excluded from the unrelated business income tax as part of the general tax exclusion for these organizations' investment income. Premiums for options which are allowed to lapse or are terminated are generally treated as ordinary income, however, and are subject to the unrelated business income tax. The enrolled bill would add gains from the lapse or termination of options to buy or sell securities to the exempt category of income for tax exempt organizations. The report of the House Ways and Means Committee states that the Committee believes the current tax treatment of income received from lapsed options is "inconsistent with the generally tax-free treatment accorded to exempt organizations' income from investment activities." The Administration has previously gone on record as supporting this provision of the enrolled bill.


Assistant Director for
Legislative Reference

Enclosures

THE WHITE HOUSE

ACTION MEMORANDUM

WASHINGTON

LOG NO.:

Date: 9/2

Time: 400pm

FOR ACTION:

Bill Seidman *ms*
Ken Lazarus *ms*
Paul Leach *ms*
may

cc (for information):

Jack Marsh
Jim Connor
Ed Schmults

FROM THE STAFF SECRETARY

DUE: Date: ~~September~~ 2

Time: 530pm

SUBJECT:

H.R. 3052-Extension of 1976 tax withholding rates and tax treatment of options to buy or sell securities

ACTION REQUESTED:

For Necessary Action

For Your Recommendations

Prepare Agenda and Brief

Draft Reply

For Your Comments

Draft Remarks

REMARKS:

please return to judy johnston, ground floor west wing



PLEASE ATTACH THIS COPY TO MATERIAL SUBMITTED.

If you have any questions or if you anticipate a delay in submitting the required material, please telephone the Staff Secretary immediately.

K. R. COLE, JR.
For the President

Date: 2

Time: 400pm

FOR ACTION:

Bill Seidman
Ken Lazarus
Paul Leach
Max Friedersdorf

cc (for information):

Jack Marsh
Jim Connor
Ed Schmults

FROM THE STAFF SECRETARY

DUE: Date: September 2

Time: 530pm

SUBJECT:

H.R. 3052-Extension of 1976 tax withholding rates
and tax treatment of options to buy or sell securities

ACTION REQUESTED:

 For Necessary Action For Your Recommendations Prepare Agenda and Brief Draft Reply For Your Comments Draft Remarks

REMARKS:

please return to judy johnston, ground floor west wing

*Concur with approval*PLEASE ATTACH THIS COPY TO MATERIAL SUBMITTED.If you have any questions or if you anticipate a
delay in submitting the required material, please
telephone the Staff Secretary immediately.



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET

DATE: 9-2-76

TO: Bob Linder

FROM: Jim Frey

Attached is the Treasury views letter on H.R. 3052, for inclusion in the enrolled bill file. Thanks.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

SEP 2 1976

ASSISTANT SECRETARY

Dear Sir:

This is in response to your request for the views of the Treasury Department on the enrolled bill H.R. 3052.

The second section of the enrolled bill would extend until September 15 the individual income tax withholding tables which expired on September 1. Due to the failure of Congress to complete action on the pending Tax Reform Bill (H.R. 10612), which includes provisions for extending the tax cuts voted last December, a temporary extension of the withholding tables is necessary to prevent an increase in withholding taxes at this time.

The withholding tax extension is being adopted without accompanying tax liability changes and, should Congress fail to enact an extension of the tax cuts, this action could result in some increased mismatching of withholding taxes and the tax liabilities of individual taxpayers. However, the Treasury Department believes that the resulting increased disparity between withholding tax collections and tax liabilities would be manageable. Of course, it is expected that Congress will enact an extension of the tax cuts, so that an extension of the present withholding tax rates will in the long run facilitate a correct matching of withholding tax collections and tax liabilities. Section two of the bill also makes necessary technical changes in the individual and corporate estimated tax provisions. In the judgment of the Treasury Department, an extension of the withholding tax tables is the most appropriate action at the present time.

The first section of the enrolled bill would make a minor amendment to section 512 of the Internal Revenue Code. Under present law, premiums received for options which are exercised are treated as part of the gain or loss from the sale of the property involved. Thus, such premium is generally treated as a capital gain or loss. However, in cases where options are allowed to lapse without being exercised the premium is generally taxed as ordinary income.

In the case of most exempt organizations section 512(b) of the Code excludes from the definition of unrelated business taxable income certain categories of investment income. The types of investment income excluded include dividends, interest, annuities, royalties, and capital gains from the sale of investment assets. In general, ordinary income items are not excluded. As a result, exempt organizations which write options to buy and sell as part of their investment programs obtain inconsistent tax treatment of their income from these activities depending upon whether or not the written options are exercised or are allowed to lapse.

It is argued that this difference in tax treatment between income from lapsed options and income from exercised options is not warranted since the writing of options on securities in both of these circumstances is essentially an investment-type activity. What is more, the act which triggers the income characterization is not under the control of the exempt organization. Whether premium income will be treated as capital gain or ordinary income depends upon whether or not the holder of the option decides to exercise it.

In order to provide consistent tax treatment for premium income realized by an exempt organization, section one of H. R. 3052 amends section 512(b)(5) of the Code to exclude from the term "unrelated business taxable income" all gains on the lapse or termination of options to buy or sell securities, when those options have been written in connection with the exempt organization's investment activities.

Treasury did not oppose the enactment of section one of H. R. 3052. This position is the same as was taken by Treasury on a similar bill (H. R. 11196, 92d Cong., 2d Sess.) which was reported favorably out of the Ways and Means Committee on February 7, 1972 (H. R. Report No. 92-826). This provision will have no effect, or at most a negligible effect, on the revenues.

The Treasury Department recommends that the President approve H. R. 3052.

Sincerely yours,

Charles M. Walker
cm

Charles M. Walker
Assistant Secretary

Director, Office of Management and Budget
Attention: Assistant Director for
Legislative Reference, Legislative
Reference Division
Washington, D. C. 20503

Date: 9/2

Time: 400pm

~~FOR ACTION:~~Bill Seidman
Ken Lazarus
Paul Leach
Max Friedersdorf

cc (for information):

Jack Marsh
Jim Connor
Ed Schmults

FROM THE STAFF SECRETARY

DUE: Date: September 2

Time: 530pm

SUBJECT:

H.R. 3052-Extension of 1976 tax withholding rates
and tax treatment of options to buy or sell securities

ACTION REQUESTED:

 For Necessary Action For Your Recommendations Prepare Agenda and Brief Draft Reply For Your Comments Draft Remarks

REMARKS:

please return to judy johnston, ground floor west wing

Recommend approval.
Barry Roth 9/2/76PLEASE ATTACH THIS COPY TO MATERIAL SUBMITTED.If you have any questions or if you anticipate a
delay in submitting the required material, please
telephone the Staff Secretary immediately.

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

SEP 2 1976

MEMORANDUM FOR THE PRESIDENT

Subject: Enrolled Bill H.R. 3052 - Extension of 1976 tax
withholding rates and tax treatment of options
to buy or sell securities
Sponsor - Rep. Rostenkowski (D) Illinois

Last Day for Action

September 13, 1976 - Monday
Recommend action as soon as possible

Purpose

To extend to September 15, 1976, certain provisions of the
Tax Reduction Act of 1975 and to exclude from the unrelated
business income tax income which an exempt organization
receives in cases where an option to buy or sell securities
is allowed to lapse or is terminated.

Agency Recommendations

Office of Management and Budget

Approval

Department of the Treasury

Approval (Information)

Discussion

H.R. 3052 would continue until September 15, 1976, the individual
income tax withholding rates and related individual and corporate
estimated tax provisions which expired on September 1, 1976.
The extension of these rates and related provisions is required
because Congress has failed to complete action on the Tax
Reform Act (H.R. 10612), now in conference. In the absence of
this extension, individual withholding rates would return to
the higher levels in effect prior to the enactment of the 1975
Tax Reduction Act.

TAX TREATMENT OF CERTAIN OPTION INCOME OF EXEMPT ORGANIZATIONS

MAY 14, 1976.—Committed to the Committee of the Whole House on the
State of the Union and ordered to be printed

Mr. ULLMAN, from the Committee on Ways and Means,
submitted the following

REPORT

[To accompany H.R. 3052]

The Committee on Ways and Means, to whom 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, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment is as follows:

Page 2, beginning in line 4, strike out "after January 1, 1975" and insert in lieu thereof "on or after January 1, 1976, in taxable years ending on or after such date".

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 invest-

ment 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

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. § 1-1234-2(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).

organization 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 cannot 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. Your 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 options is excluded from the base of the unrelated business income by section 512(b) of the Code."

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

⁵ Rev. Rul. 66-47, 1966-1 CB 149.

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*,⁶ 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. EFFECT OF THE BILL ON THE REVENUES AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

In compliance with clause 7 of Rule XIII of the Rules of the House of Representatives, the following statement is made relative to the effect of this bill on the revenues. Your 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 compliance with clause 2(1)(2)(B) of Rule XI of the Rules of the House of Representatives, the following statement is made relative to the vote of the Committee on reporting the bill. This bill, as amended, was ordered reported by voice vote.

IV. OTHER MATTERS REQUIRED TO BE DISCUSSED UNDER HOUSE RULES

In compliance with clause 2(1)(3) of the Rule XI of the Rules of the House of Representatives, the following statements are made:

With respect to subdivision (A), relating to oversight findings, it was as a result of your committee's oversight activity concerning the treatment of investment income received by exempt organizations that it concluded that the provisions of this bill are appropriate so as to equalize the tax effects of what are essentially similar types of income.

With respect to subdivision (B), your committee states that the changes made to existing law by this bill involve no new budget authority or new or increased tax expenditures.

With respect to subdivisions (C) and (D), your committee advises that no estimate or comparison has been submitted to your committee by the Director of the Congressional Budget Office relative to any of the provisions of H.R. 3052 nor have any oversight findings or recommendations been submitted to your committee by the Committee on Government Operations with respect to the subject matter of H.R. 3052.

⁶ 244 F. 2d 803 (C.A. 9, 1957).

In compliance with clause 2(1)(4) of Rule XI of the Rules of the House of Representatives, your committee states that the enactment of this bill is not expected to have an inflationary impact on prices and costs in the operation of the national economy.

V. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 of rule XIII of the Rules of the House of Representatives, 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

* * * * *

SUBTITLE A—INCOME TAXES

* * * * *

CHAPTER 1—NORMAL TAXES AND SURTAXES

* * * * *

PART III—TAXATION OF BUSINESS INCOME OF CERTAIN EXEMPT ORGANIZATIONS

* * * * *

SEC. 512. UNRELATED BUSINESS TAXABLE INCOME.

(a) * * *

* * * * *

(b) MODIFICATIONS.— * * *

* * * * *

(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 (e)).

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.

* * * * *

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-

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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(e)) 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

*	*	*	*	*	*	*
SUBTITLE A—INCOME TAXES						
*	*	*	*	*	*	*
CHAPTER 1—NORMAL TAXES AND SURTAXES						
*	*	*	*	*	*	*
PART III—TAXATION OF BUSINESS INCOME OF CERTAIN EXEMPT ORGANIZATIONS						
*	*	*	*	*	*	*

SEC. 512. UNRELATED BUSINESS TAXABLE INCOME.

(a) * * *

* * * * *

(b) MODIFICATIONS.— * * *

* * * * *

(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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Ninety-fourth Congress of the United States of America

AT THE SECOND SESSION

*Begun and held at the City of Washington on Monday, the nineteenth day of January,
one thousand nine hundred and seventy-six*

An Act

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.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 512(b)(5) of the Internal Revenue Code of 1954 (relating to modifications to unrelated business taxable income) is amended by inserting after the first sentence the following new sentence: "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)).".

(b) The amendment made by subsection (a) shall apply to gain from options which lapse or terminate on or after January 1, 1976, in taxable years ending on or after such date.

SEC. 2. (a) The following provisions of the Internal Revenue Code of 1954 are amended by striking out "September 1, 1976" and inserting in lieu thereof "September 15, 1976":

- (1) section 3402(a) (relating to income collected at source);
- (2) section 6153(g) (relating to installment payments of estimated income tax by individuals); and
- (3) section 6154(h) (relating to installment payments of estimated income tax by corporations).

(b) Section 209(c) of the Tax Reduction Act of 1975 is amended by striking out "September 1, 1976" and inserting in lieu thereof "September 15, 1976".

Speaker of the House of Representatives.

*Vice President of the United States and
President of the Senate.*

9/7/76

Mr. J. -

F-11 - and to add to
the file, pls. Thanks.

Kate

THE WHITE HOUSE

WASHINGTON

September 6, 1976

MEMORANDUM FOR THE PRESIDENT

FROM: JIM CAVANAUGH

SUBJECT: Tax Statement

Attached for your approval is a statement to be issued today with your views on the tax situation.

You will recall that you signed the withholding tax extension on Friday.

The statement has been reviewed and approved by Jim Lynn, Paul O'Neill, Bill Seidman (Roger Porter), and Bob Hartmann.

*OK per file
Cheney*

_____ Approve

_____ Disapprove

STATEMENT BY THE PRESIDENT

In signing into law a brief extension of tax withholding rates, I call the Nation's attention once again to the continuing inability of the Congress to meet the real needs of the American taxpayer.

For many months, the Congress has been struggling with the issue of tax reduction and tax reform. Most Americans agree that both are necessary.

In January I expressed my own view that one of the most important advances this Congress could make would be to restrain the growth of Federal spending and return the savings to the taxpayers in the form of a \$10 billion permanent and additional reduction in income taxes.

During the year I have also recommended to the Congress in the strongest possible terms the need for reform of estate and gift taxes, so that family farms and small businesses would not be wiped out upon death in the family.

As I have said many times, we must relieve the burdens on all taxpayers and make our tax system more equitable.

Unfortunately, the Congress has become ensnarled in the rewriting of detailed provisions of the tax code and has failed to recognize the broad interests of the country:

-- It has failed to grant additional tax relief;

-- It has failed to put adequate restraints on spending;

-- It has failed to protect family farms and small businesses from the burdens of heavy taxation.

The bill that I am signing is only a bandaid -- a 15-day respite so that the Congress can hopefully complete action on a more comprehensive tax package. I urge that the Congress use this time wisely -- that it consider the needs not just of the special interests, but of all the American people. I pledge that I shall do everything I can to assist in this effort.

Office of the White House Press Secretary

THE WHITE HOUSE

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