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Introduction

This booklet summarizes the basic rules governing the federal income taxation of certain investments by individuals who are citizens or residents of the United States and who dispose of an investment in a taxable transaction. It is not a treatise on the taxation of securities. Examples have been provided whenever appropriate. Generally, the effect of commissions has not been taken into account. Corporations, tax-exempt entities and other similar professional investors may be subject to somewhat different rules than those described herein and are not the subject of this booklet.

This edition of *Taxes and Investing: A Guide for the Individual Investor* reflects changes in the federal income tax law through and including the Commodity Futures Modernization Act of 2000 and the Community Renewal Tax Relief Act of 2000 (the “2000 Acts”).

Capital Gains and Losses

Short-term capital gains, as well as compensation, business profits, interest and dividends, are subject to a marginal tax rate of up to 39.6%.

For sales after December 31, 1997, by calendar year individuals in the top tax bracket, a “maximum” tax rate of 20% applies to net capital gains (net long-term capital gains minus net short-term capital losses) with a holding period of more than 12 months. Legislation enacted in 1998 eliminated the more than 18 months holding period that had been required in order to obtain the lowest capital gain rates.

This 20% rate (as well as the marginal tax

rates on the “ordinary” and short-term capital gain income noted above) may effectively be even higher due to the impact of the limitation on itemized deductions and the phase-out of personal exemptions for certain taxpayers.

With an up to 19.6 percentage point spread between the 20% long-term and 39.6% short-term capital gain tax rates, individual investors with profitable positions may in some cases have an incentive to hold such positions for an extended period of time. In evaluating investment decisions, investors must also take into account any effect of the individual alternative minimum tax (“AMT”).

In general, the AMT is imposed on a graduated two-tier basis, 26% and 28%, based on the amount of alternative minimum taxable income. However, the tax law conforms the capital gains tax rate a taxpayer would pay under the regular tax with the rate for AMT purposes through an AMT capital gains tax rate. This rate equals the capital gains tax rate under the regular tax, depending on the type of asset and the length of holding period. Accordingly, capital gains alone should not affect whether a taxpayer becomes subject to the AMT.

Losses are subject to certain limitations. Capital losses (long-term as well as short-term) are allowed in full to the extent of capital gains plus $3,000 of ordinary income. Special netting rules apply to take into account the multiple rates for long-term capital gains.

The use of the installment method of reporting for sales of publicly traded property is not permitted. Individuals are required to recognize gain or loss on the sale of publicly traded stock and securities on the day the trade is executed.

Short Sales and Constructive Sales

The short-sale rules deal with the selling of property in a short sale where the taxpayer holds or subsequently acquires “substantially identical property.” Historically, the effect of the short-sale rules has been that if the long position has been held for one year or less at the time of the short sale, or if substantially identical property is acquired after the short sale, gain on closing that short sale is a short-term capital gain (notwithstanding the period of time any property used to close the short sale has been held). In addition, the holding period of the long position (to the extent of the quantity sold short, in the order of the dates of acquisition) is terminated, not suspended. The holding period of the long position begins only after the short sale has been closed, or the substantially identical property is sold or otherwise disposed, whichever occurs first.

Also, if the long position has already been held more than 12 months at the time of the short sale, no termination of holding period occurs and any loss on closing the short sale is a long-term (maximum 20% tax rate) capital loss. A taxpayer can deliver against the short position, for long-term capital gain, stock held more than 12 months at the time of the short sale, provided that no other substantially identical property was held short-term at the time of, or acquired after, the short sale.

Reducing the risk of loss by being under a contractual obligation to sell or holding an option to sell (a “put”) has been treated as a short sale for purposes of the short-sale rules, but a “married put” has been exempted from these short-sale rules (see discussion of the “Married Put” on page 15).

The “substantially identical” test requires that the securities be of the same issuer and be commercially identical in all major respects, including inter-

est rate, maturity date, dividend provisions, liquidating preferences and other similar priorities. If the instruments are virtually similar or identical, the overriding test is whether or not the marketplace views them as such, i.e., whether or not movement of one security correlates to the price movement of the other security. Thus, if a graph of relative price movements produces parallel lines, the securities are generally substantially identical. If such a result does not occur, they are not substantially identical.

As a result of the "constructive sale" rule and subject to various exceptions, a taxpayer must recognize gain (but not loss) upon entering into a constructive sale of any appreciated position in stock, a partnership interest or certain debt instruments that effectively eliminates both the taxpayer's risk of loss and upside gain potential. Entering into short sales, futures or forward contracts are examples of transactions that may generate constructive sales. Where a short position has appreciated, the acquisition of stock may result in a constructive sale. Other transactions to be covered by these rules may be identified in Treasury regulations to be issued.

Upon a constructive sale event, gain is recognized as if the position were sold at its fair market value on the date of sale and immediately repurchased. The basis of the appreciated position is increased by any gain realized, and a new holding period begins as if the position had been acquired on the date of the constructive sale.

The constructive sale rule does not apply to certain closed transactions during a taxable year that meet three conditions: (1) the transaction is closed before the end of the 30th day after the close of such taxable year; (2) the position is held throughout the 60-day period beginning on the date such transaction is closed; and (3) during such 60-day period, the taxpayer does not enter into certain transactions (except "qualified covered calls", discussed on page 15) that would diminish the risk of loss during that time on such position. A special rule applies where the closed transaction is reestablished within that 60-day period and the reestablished transaction is closed by the 30th day after the close of the year of the initial transaction.

A transaction that results in a constructive sale of one appreciated position is not treated as resulting in the constructive sale of another appreciated position so long as the taxpayer holds the position which was treated as constructively sold. However, when that position is sold or otherwise disposed, the transaction can cause a constructive sale of another appreciated position.

If less than all of a position is constructively sold, the taxpayer may specifically identify what has been "sold". Absent that identification, the position is deemed to be sold in the order acquired (i.e., on a "first in, first out" basis).

The constructive sale provision is generally effective for constructive sales entered into after June 8, 1997. Special rules apply to transactions before that date that would otherwise have been constructive sales under this new provision.

Options are not specifically covered, but the legislative history is very clear that many transactions involving options, including the buying or writing of certain in-the-money options, will be subject to the constructive sale rule through the issuance of Treasury regulations. In determining whether a particular transaction will be treated as a constructive sale, the Treasury regulations may take into account the yield and volatility of the underlying stock, the length of time until maturity and other terms of the option. The regulations may also rely on option prices and option pricing models. However, transactions involving stock and also out-of-the-money options, at-the-money options or qualified covered calls should not trigger the constructive sale rule.

Transactions discussed in this booklet involving options do not reflect the potential application of the constructive sale rule in advance of regulatory guidance.

Example:
On September 1, 2000, an investor buys 100 shares of X Co. for $50 per share. On November 17, 2000, the investor sells short 100 shares of X Co. for $60 per share. On January 5, 2001, the investor closes the short position by delivering the 100 shares owned. Entering the short sale on November 17 is a constructive sale, resulting in a $1,000 gain in 2000. Since the 100 shares bought on September 1 are treated as sold and repurchased for $60 upon entering the short sale, no further gain or loss is realized on closing the short position.

Example:
Using the prior example, the investor acquires 100 shares of X Co. "in the market" on January 5, 2001 for $65 per share and delivers those shares to cover the short position on January 8, 2001. The investor holds the shares of X Co. acquired in September "naked" for 60 days after the covering of the short position. There is no constructive sale of X Co. stock in 2000. However, the investor realizes a $5 per share loss on covering the short position.

Example:
On November 2, 2000, an investor buys 100 shares of Y Co. for $25 per share. On December 8, 2000, the investor sells 100 shares of Y Co. short for $20 per share. There is no constructive sale on December 8 because the investor's Y Co. shares were not appreciated at the time of the short sale.

Example:
On February 2, 2000, an investor buys 200 shares of Z Corp. stock at $30 per share. On April 17, 2000, the investor buys at-the-money puts (exercise price equals current market price of the underlying stock) on the 200 shares when the stock is $40 per share. The acquisition of the at-the-money put does not trigger the constructive sale rules because the option reduces only the investor's risk of loss. However, the straddle rules may apply. See page 13.

Wash-Sale Rule

The wash-sale rule prevents taxpayers who are not dealers from selling stock or securities (including options) at a loss and reacquiring "substantially identical" stock or securities (or options to acquire substantially identical stock or securities) within a 30-day period before or after the loss. The wash-sale rule also prevents such taxpayers from currently recognizing losses on the closing of short sales if, within 30 days before or after the closing, substantially identical stock or securities are sold or the taxpayer enters into another short sale of substantially identical stock or securities.

The meaning of the term "substantially identical property" is generally the same as in the case of the short-sale rules.

When the wash-sale rule is applicable, the loss is disallowed and the basis of the new property is deemed to be the basis of the original property, increased or decreased, as the case may be, by the difference between the cost of the new property and the price at which the old property was sold. The holding period of the original property is added to the holding period of the newly-acquired property.

In addition, the Internal Revenue Service has taken the position that the wash-sale rule will disallow a loss on the sale of stock if, within 30 days before or after the sale of the stock, the taxpayer sells an "in-the-money" put option with respect to the stock and, on the basis of objective factors at the time the put was sold, there is a substantial likelihood that the put will be exercised. These factors include the spread at the time the put is sold between the value of the underlying stock and the exercise price of the put, the premium paid and the historic volatility in the value of the stock.

Example:
On January 5, 2000, an investor sells short 100 shares

of ABC Co. for $50 per share. On April 3, 2000, the investor purchases 100 shares of ABC Co. at $55 per share and delivers the stock to close the short position, resulting in a $500 loss. The constructive sale rule does not apply because there is no appreciated position. On April 27, 2000, the investor sells short 100 shares of ABC Co. for $50 per share. The $500 loss on the closing of the first short sale is disallowed because the investor, within 30 days after closing the short sale at a loss, entered into another short sale of substantially identical stock. That loss will reduce any gain in the case of a subsequent constructive sale, or will increase any loss on the closing of the second short sale if there is no constructive sale.

Example:
On January 5, 2000, an investor sells short 100 shares of DEF Co. for $30 per share. On February 14, 2000, the investor purchases 300 shares of DEF Co. at $35 per share and delivers 100 of the shares to close the short sale. The constructive sale rule does not apply because there is no appreciated position. On February 25, 2000, the investor sells 100 of the shares of DEF Co. The $500 loss on the closing of the short sale is disallowed because the investor, within 30 days after closing the short sale at a loss, sold substantially identical stock. This loss will reduce any gain (increase any loss) on the sale of the remaining DEF Co. stock.

One-Sided Equity Option Positions

The treatment of gain or loss as long-term or short-term may have great significance for equity options because of the potentially substantial long-term capital gain rate differential.

Long Stock and Long Calls
If stock or a call option is acquired and held for more than one year, the resulting gain or loss on the sale is a long-term capital gain or loss (maximum tax rate of 20%). If the stock or call is purchased and sold in one year or less, any resulting gain or loss is short-term. Expiration of a call is treated as a sale or exchange on the expiration date and results in a short-term or long-term capital loss, depending on the holding period of the call. If the call is exercised, the premium paid, the strike price, the brokerage commission paid upon exercise, and the commission on the call's purchase are included in the basis of the stock. The holding period of the stock acquired begins on the day after the call is exercised and does not include the holding period of the call.

Short Calls
Premium received for writing a call is not included in income at the time of receipt, but is held in suspense until the writer's obligation to deliver the underlying stock expires or until the writer either sells the underlying stock as a result of the assignment of the call or closes the option (other than by expiration or assignment). If the writer's obligation expires, the premium is short-term capital gain to the writer upon expiration, regardless of the length of time the call is outstanding.

Similarly, gain or loss on the termination of the writer's obligation through closing the option other than by expiration or assignment is short-term capital gain or loss, regardless of the length of time the call is outstanding. However, if a call is assigned, the strike price plus the premium received becomes the sale price of the stock in determining gain or loss. The resulting gain or loss depends upon the holding period and the basis of the underlying property used to make the delivery to satisfy the assignment. It is possible that previously owned stock will be long-term and, thus, without taking into account the offsetting position rules discussed

on page 13, may result in long-term capital gain or loss (20% maximum tax rate).

Long Puts

If a put option is acquired and sold prior to exercise, any gain or loss is short-term or long-term capital gain or loss, depending on the holding period of the put. The expiration of a long put results either in a short-term capital loss if the put is held one year or less or in a long-term capital loss (20% maximum tax rate) if held for more than one year. If the put is exercised, the cost of the put and the commission on the sale of the stock reduce the amount realized upon the sale of the underlying stock delivered to satisfy the exercise.

Short Puts

Like the call premium, the put premium is held in suspense until the put writer's obligation is terminated. Closing an uncovered put before assignment always results in short-term capital gain or loss. If the put expires, the writer realizes a short-term capital gain to the extent of the premium received. If the put is assigned, the strike price plus commission less the premium received for writing the put become the basis of the stock acquired, and a new holding period begins for the stock on the day after the stock's purchase.

Treatment of Gain or Loss
on Disposition of One-Sided Equity Options
(If Not Exercised)

Maximum Life of Option at Acquisition or Grant	Long Call	Short Call	Long Put	Short Put
Less than or equal to 1 year	Short-term	Short-term	Short-term	Short-term
Greater than 1 year	Short- or Long-term	Short-term	Short- or Long-term	Short-term

Offsetting Positions

A straddle for Federal income tax purposes involves the holding of "offsetting positions" with respect to personal property. The concept of offsetting positions for individuals embodies a "substantial diminution of risk of loss" test. A taxpayer has diminished risk of loss where changes in the fair market value of the positions are reasonably expected to vary inversely. If either position composing the straddle materially diminishes the risk of loss on the other position, it would appear that there is substantial diminution of risk of loss. Risk diminution does not require mutuality.

Once an investor holding two or more positions meets the substantial diminution of risk of loss test, the consequences are as follows:

1. There is a suspension or termination of the holding period during the period of offset (see Appendix II).

2. The wash-sale rule applies to defer losses realized on certain straddle positions (see page 9).

3. No current deduction for losses is allowable to the extent of the unrecognized gain (if any) at the end of the taxable year in "offsetting positions" to the loss position, "successor positions" and "offsetting positions to the successor positions." Deferred losses are treated as sustained in the next taxable year, but they are again deferred to the extent of any offsetting unrecognized gain at the end of such year and not otherwise deferred under the wash-sale rule.

   In general, a "successor position" is a position which is on the same side of the market (long or short) as was the original position, which replaces a loss position and which is entered into

during a period commencing 30 days prior to and ending 30 days after the disposition of the loss position. However, a position entered into after all positions of a straddle have been disposed will not be considered a successor position.

4. All carrying charges and interest expenses (including margin) incurred during the period of offset are required to be capitalized and added to the basis of the long position. Such capitalized charges are, however, reduced by dividends received on stock included in the straddle. Such expenses are not deductible but, instead, decrease the potential capital gain or increase the potential capital loss upon disposition.

Stock acquired prior to January 1, 1984 should not be subject to these anti-straddle rules, irrespective of how long the stock may be held by the taxpayer or the nature of any other position held. However, it is possible that the Internal Revenue Service could take a different position.

Stock can be part of, but not all of, a straddle involving offsetting positions. For purposes of the anti-straddle rules, long stock against short stock is not treated as an offsetting position. The constructive sale, wash-sale and short-sale provisions, nonetheless, apply. See discussion on page 5.

Example:

An investor purchases 100 shares of XYZ Co. common stock at $30 per share on November 10, 2000. On December 15, 2000, the investor sells 100 shares of the stock short ("against-the-box") at $50 per share. On May 4, 2001, the investor purchases 100 shares of XYZ Co. stock at $50 per share. On May 15, 2001, the November 10 stock is delivered to close the short sale. The anti-straddle rules do not apply to this transaction, but the application of the constructive sale rule results in a $20 per share short-term capital gain on entering into the short sale on December 15.

The substantial diminution of risk of loss test does not require that offsetting stock positions be of the same issuer (though stock against stock alone is not an offsetting position). As a result, stock of one issuer and options on the stock of another may be viewed as offsetting positions in appropriate circumstances.

In contrast, the concept of "substantially identical" for purposes of the wash-sale and short-sale rules requires that stock and options on stock be of the same issuer.

Exceptions to Offsetting Position Rules

In general, any offsetting position that includes stock and provides a substantial diminution of risk of loss is subject to the anti-straddle provisions. Exceptions include the "qualified covered call" and, possibly, the "married put" discussed below.

Married Put

In order for a "married put" to be deemed "married," the put must be acquired on the same day as the stock and the stock must be identified as the stock to be delivered upon exercise of the put. Furthermore, the married put criteria may only be met either by delivering the married stock or by allowing the put to expire. If the put expires, the cost of the put is added to the cost basis of the stock. While the married put is exempted from the short-sale rules (see discussion on page 5), it remains unclear whether or not the married put is also exempt from the offsetting position rules.

However, temporary Treasury regulations suggest that, in the view of the Treasury, the married put is not so exempt. Further clarification is required in final Treasury regulations yet to be issued.

Qualified Covered Calls

A "qualified covered call" is an exchange-traded call option written on stock held by the investor (or stock acquired by the investor "in connection with" the writing of the option) that results in capital gain

or loss treatment to the writer. The call option must have more than 30 days to expiration and a strike price not less than the first available strike price below the closing price of the stock on the day before the option was written.

For an option written with more than 90 days to expiration and with a strike price over $50, the covered call must have a strike price no lower than the second available strike price below the closing stock price on the previous day. It should be noted that different strike price intervals (e.g., $2.50 vs. $5) may exist among the various listed option stocks for comparably priced stocks.

If the stock price is $150 or less, a qualified covered call cannot be more than $10 "in-the-money." If the closing stock price on the previous day is $25 or less, the strike price must be at least 85% of the stock price. For a table of in-the-money qualified covered calls for stock priced $25 or less, see Appendix I. In all cases, if the opening price of the stock on the day the option is written is greater than 110% of the preceding day's closing price, that opening price, rather than the preceding day's closing price, is used in determining the lowest acceptable strike price for a qualified covered call.

The following chart may help covered call writers determine which options are qualified covered calls:

"In-the-Money" Qualified Covered Calls

Previous Day's Closing Stock Price*	Lowest Acceptable Strike Price**
$25 or less More than 30 days to expiration	One strike below previous day's closing stock price (no in-the-money qualified covered call if strike price is less than 85% of stock price)
$25.01 to $60 More than 30 days to expiration	One strike below previous day's closing stock price
$60.01 to $150 31-90 days to expiration	One strike below previous day's closing stock price
$60.01 to $150 More than 90 days to expiration	Two strikes below previous day's closing stock price (but not more than $10 in-the-money)
Greater than $150 31-90 days to expiration	One strike below previous day's closing stock price
Greater than $150 More than 90 days to expiration	Two strikes below previous day's closing stock price

* If the opening price on the day the option is written exceeds the previous day's closing price by more than 10%, then the opening price is used in determining the lowest acceptable strike price.

**Whether a covered call is "qualified" is subject to certain special rules, described below.

Example:
An investor purchases shares of XYZ Co. at $61 per share on September 1, 2000 and writes a covered call on the same day. XYZ Co. closed at $61 per share on August 31. A call with a strike price of $60 is the only 31-90 day in-the-money qualified covered call that can be written. A $55 and $60 strike price call can be written if the call has more than 90 days to expiration, assuming $5 option strike price intervals. If $2.50 option strike price intervals exist for XYZ Co., a $57.50 and $60 strike price qualified covered call can be written.

Example:
Assume, instead, that the investor purchases shares of ABC Co. stock at its closing price of $114 per share. A call with a strike price of $110 is the only

31-90 day in-the-money qualified covered call that can be written. An in-the-money qualified covered call with more than 90 days to expiration may be written at $105 or $110, assuming $5 option strike price intervals.

Example:
If DEF Co. shares are purchased for $12 per share, no in-the-money qualified covered call is available at this time (see Appendix I), since the strike price must be at least 85% of the stock price (note that the $10 strike price options are less than 85% of $12).

Example:
An investor purchases 100 shares of BCD Co. stock at $42 per share on June 30, 2000. On August 4, 2000, the investor writes a BCD/September/40 call, receiving a premium of $3. BCD Co. closes at $42 per share on August 3. On September 13, 2000, the investor unwinds his/her options position by making a closing purchase at $5. Since the call was written on stock held by the investor, it is a "qualified covered call."

Even if the stock price/strike rules are satisfied, a call that is not an option to purchase stock acquired by the investor "in connection with" the granting of the option would not be qualified. For example, a call written on October 9, 2000 will not be qualified if the stock is purchased on October 13, 2000.

Covered Calls - Special Rules
The basic thrust of the anti-straddle rules is to prevent mismatching of gain and loss. This is accomplished by requiring loss deferral. Writing an at-the-money (strike price of call equals the stock price used in determining the lowest acceptable strike) or an out-of-the-money (above-the-market) qualified covered call allows the holding period of the underlying stock to continue. However, an in-the-money qualified covered call suspends the holding period of the stock during the time of the option's existence. Further, any loss with respect to an in-the-money qualified covered call is treated as long-term capital loss, if at the time the loss is realized, gain on the sale or exchange of the underlying stock would be treated as long-term capital gain.

Additionally, when a covered call is disposed at a loss in one year and the stock is still owned on the first day of the subsequent year, there is a requirement that the stock be held an additional 30 days from the date of disposition of the call in order for the covered call to be treated as "qualified" for purposes of the loss deferral rule (see page 13). Generally, only days on which the stock is held "naked" may be counted in determining whether the 30-day holding period is satisfied. However, for this rule the holding period continues to run while the taxpayer is the writer of qualified covered calls.

Similarly, a covered call is not treated as "qualified" for purposes of the loss deferral rule if the covered call is not held for 30 days after the related stock is disposed of at a loss, where gain on closing the option is included in the subsequent year. This rule applies to positions established after December 31, 1986.

Example:
On December 1, an investor purchases 100 shares of ABC Co. stock at $36 per share. On the same day, the investor writes an ABC/February/35 call, receiving a premium of $3. On December 15, the investor unwinds his/her position in the ABC/February/35 call by making a closing purchase at $5. On May 1 of the subsequent year, the investor sells the 100 shares of ABC Co. stock at $45 per share. No positions, long or short, in ABC Co. stock or options are established by the investor after the option closing purchase on December 15 and prior to the sale of the stock on May 1. The covered call is qualified, because the ABC Co. stock is held for 30 days or more after the close of the call at a loss in the year preceding the sale of the stock at a gain.

Example:
On November 6, 2000, an investor purchases 100 shares of XYZ Co. stock at $42. On the same day, the investor writes an XYZ/February/40 call receiving a premium of $4. On December 27, 2000, the investor unwinds his/her position in the XYZ/February/40 call by making a closing purchase of $6. On January 5, 2001, the investor sells the XYZ Co. stock for $46. The covered call is not qualified, because the XYZ Co. stock is not held for 30 days after the close of the call at a loss in the year preceding the sale of the stock at a gain. The loss on the call is deferred until 2001.

Example:
Using the prior example, if the investor acquires an XYZ Co. put on December 27, 2000 and sells the XYZ Co. stock at a gain on February 2, 2001 (the put remaining unexercised on the date of sale), the covered call is not qualified because the stock will not have had 30 "good" days of holding period. The loss on the call is deferred until 2001.

Example:
On November 17, 2000, an investor purchases 100 shares of BCD Co. stock at $52. On the same day the investor writes a BCD/January/50 call, receiving a premium of $5. On December 22, the investor sells the BCD Co. stock at $50 per share, a $2 loss per share. On January 4, 2001, the investor enters into a closing transaction on the option at a gain of $1. The covered call is not qualified, because the BCD Co. option is not held for 30 days after the sale of the stock at a loss in the year preceding the sale of the option at a gain. The loss on the stock is deferred until 2001. The result would be the same if the option expires unassigned at a gain.

Stock and Non-Equity Index Instruments

"Mark-to-market" and "60/40" (i.e., 60 percent long-term, 40 percent short-term) treatment applies to "broad-based" U.S. stock index options (such as the Standard & Poor's® 100 Index option, the NYSE Composite Index® option and the Dow Jones Industrial Average℠ option at CBOE and the Major Market Index option at Amex) and options on stock index futures, such as the option on the Standard & Poor's® 500 Stock Index future at the Chicago Mercantile Exchange and the option on the NYSE Composite Index® future at the New York Futures Exchange.

This tax treatment also applies to regulated futures contracts and certain options where the underlying property is not equity based, such as interest rate, foreign currency (for example, those traded on PHLX), and commodity options and futures options. These instruments are referred to as "Section 1256 contracts."

Options on a stock index that is "narrow based" are subject to the rules governing the taxation of equity options and are not entitled to 60/40 mark-to-market treatment.

With the enactment of the 2000 Acts, as of December 21, 2000, what constitutes a narrow based index has been significantly limited. Under the new definition, an index generally is narrow based only if (i) it contains 9 or fewer component securities, (ii) a component security comprises more than 30% of the index's weighting, or (iii) the 5 highest weighted component securities in the aggregate comprise more than 60% of the index weighting. Previously, options on a stock index of a type that had neither been designated by the Commodity Futures Trading Commission (CFTC) as eligible for trading on a commodity futures exchange nor had been determined by the Treasury to be eligible for such designation generally were treated as narrow based unless

the Securities and Exchange Commission had determined that the index was broad based for regulatory purposes.

Foreign equity index warrants traded on U.S. exchanges are subject to the same tax considerations as options. Thus, foreign equity index warrants such as the CAC 40 warrant and the Hong Kong 30 Index warrant should be treated as Section 1256 contracts.

For individual investors, assets which require mark-to-market treatment generally must be treated as sold at their fair market value on the last business day of the taxable year (and simultaneously repurchased), even if they have not been disposed. For all of these assets, the gains and losses, both actually realized during the year and deemed realized (by virtue of being marked-to-market at year-end), are aggregated. The combined gains and losses are netted, and the net gain or loss is then treated as 60% long-term capital gain or loss (entitled to the maximum 20% long-term tax rate) and 40% short-term capital gain or loss. This long-term and short-term capital gain is treated as any other capital gain. Therefore, other capital losses offset these gains. Net short-term capital gain but not net long-term capital gain is investment income for investment interest limitation purposes. See discussion of "Investment Income and Other Investment Expenses" (page 32).

For those positions marked-to-market at year-end, the basis for determining gain or loss is the new mark-to-market value. This prevents the gain or loss from being counted twice. It is possible that a Section 1256 contract having a gain attributable to it in one year could have a loss attributable to it in the next. These gains and losses cannot be netted in one year's return, but are shown in the separate years as a separate gain and a separate loss (that is, combined with all the other Section 1256 contracts). The exercise of a Section 1256 contract is generally treated as a disposition of a Section 1256 contract.

Exchange Traded Fund Shares

Exchange traded fund shares are interests in open-end investment companies that hold securities constituting or based on an index or portfolio of securities. Examples of such shares are Standard & Poor's Depositary Receipts ("SPDRs"), NASDAQ-100 Index Tracking Stock and DIAMONDS. These shares are generally taxed as interests in a regulated investment company ("mutual fund") for Federal income tax purposes. Thus, dividends paid from investment income (including dividends, interest and net short-term capital gains) are taxable to beneficial owners as ordinary income. Similarly, capital gain distributions from net long-term capital gains are taxable as long-term capital gains regardless of the length of time an investor has owned the fund shares.

In addition, there are listed options on certain exchange traded fund shares. Where the underlying portfolio or index is not broad based (see discussion on page 21), the related option is taxed as a regular equity option (page 10). The taxation of options on exchange traded fund shares where the underlying portfolio or index is broad based is currently uncertain and requires guidance from the Treasury.

Mixed Straddles

When a straddle consists of both Section 1256 contracts (discussed above) and non-Section 1256 positions, a "mixed straddle" results. The taxation of mixed straddles is exceedingly complex and is dependent, in part, on whether certain elections are made, whether net gain or loss is attributable to the Section 1256 or to the non-Section 1256 positions and whether mark-to-market rules apply.

The significance of a mixed straddle can be great as a result of the rate differential between long-term and short-term capital gain and loss. Loss deferral and capitalization rules also apply (see page 13). A straddle where at least one position is ordinary and one is capital will also be a mixed straddle.

Bonds and Other Debt Instruments

The Federal income tax consequences of investing in corporate debt obligations are somewhat more complex than the tax consequences of investing in stocks. The general rule is that an investor will realize long-term or short-term capital gain, or may sustain long-term or short-term capital loss, as the case may be, on the sale of corporate debt obligations.

In recent years, however, the general rule has been eroded by a series of provisions dealing with "original issue discount," "market discount," "premium" and "short-term" obligations. In addition, special rules apply if the obligation is debt-financed (e.g., "margined"). These rules typically convert capital gain to ordinary income, cause certain income to be recognized currently for tax purposes, or match interest income and interest expense.

Original Issue Discount

The original issue discount (OID) provisions apply to debt obligations issued at a discount from the principal amount of the obligation. The amount of OID is the excess of the stated redemption price at maturity over the issue price of the obligation. De minimis amounts of OID (less than ¼ of 1% of the stated redemption price at maturity multiplied by the number of complete years to maturity) are not taken into account. A holder of a debt obligation with OID is required to currently include in income, during the period the bond is held, the amount of OID attributable to each taxable year. The OID included in income is treated as ordinary interest income. With respect to corporate obligations issued after July 1, 1982, OID is computed on an "economic accrual" (constant interest) basis. OID on corporate obligations issued before July 2, 1982 is included in income ratably. The amount of OID included in income in either case is added to the basis of the obligation.

Under the economic accrual method, OID accrues in a manner similar to the accrual of interest on deposits by financial institutions. The ratable share of OID is based on the number of days the taxpayer holds the obligation after its acquisition relative to the number of days until maturity.

Although OID on tax-exempt obligations is not includible in the investor's taxable income, it must still be taken into account. OID on tax-exempt obligations accrues on an economic accrual basis and increases the investor's basis in the obligation for purposes of determining gain or loss on its disposition or payment at maturity.

Zero coupon bonds are generally subject to the OID rules.

OID concepts also apply to certain redeemable preferred stock issued after October 9, 1990 with redemption premium. Like OID,

redemption premium exists if the redemption price at maturity exceeds the issue price by more than a de minimis amount (same standard is applied in the case of OID). While such stock is not debt for Federal income tax purposes, the entire amount of the redemption premium is treated as being distributed to holders on an economic accrual basis over the period that the stock is outstanding. The income tax consequences of such a distribution to an individual shareholder depend on the paying corporation's current and accumulated earnings. The distribution could result either in currently taxable ordinary income, capital gain, or nontaxable return of capital (in the latter case with an equivalent reduction in the basis of the stock).

Market Discount

Debt obligations are subject to the market discount rules in addition to the OID rules. The market discount rules apply to debt obligations acquired at a discount in contrast to those issued at a discount. Market discount is the difference, if any, between the stated redemption price at maturity and the taxpayer's basis for the obligation immediately after its acquisition.

As with OID, market discount is generally treated as ordinary interest income. However, it is not taxable until the disposition of the obligation by the taxpayer. The taxable amount of market discount is the amount that has accrued during the period the taxpayer has held the bond. If the market discount is less than ¼ of 1% of the stated redemption price at maturity multiplied by the number of complete years to maturity (after the taxpayer acquired the bond), the market discount is treated as zero.

This ordinary income treatment did not generally apply to tax-exempt obligations or to market discount obligations issued on or before July 18, 1984. Special rules applied to debt-financed market discount obligations issued on or before July 18, 1984, but acquired after that date. This ordinary treatment applies to tax-exempt obligations and to all market discount obligations issued on or before July 18, 1984 if the obligations are acquired after April 30, 1993.

Market discount is treated as accruing in equal daily installments; however, at the election of the taxpayer on an obligation-by-obligation basis, it can be computed on an economic accrual method.

Example:

On July 1, 1997, an investor acquires $100,000 face amount XYZ 12s, due July 1, 2001, for $96,000. The obligations were issued January 1, 1995 at par. The obligations are sold on July 1, 1999 for $99,000. The tax consequences in the year of sale are as follows (assuming straight line accrual of market discount and excluding the effect of accrued coupon interest purchased and sold):

Realized gain ($99,000–$96,000)	*$3,000*
Gain treated as ordinary income ($4,000 market discount x 730/1461)	*$2,000*
Long-term capital gain	*$1,000*

The market discount and OID provisions can apply simultaneously to an obligation. An investor will have market discount if an OID obligation is purchased for less than the issue price plus the amount of accrued OID on the obligation since the date of issue.

Example:

XYZ Corp. $1,000 face amount 12s, due September 1, 2000, were issued on September 1, 1996 for $960. On September 1, 1997, an investor acquires $100,000 face amount of the bonds for $95,913. The amount of OID that has accrued on the bonds since the issue date (using the economic accrual method) is $813. Therefore, since the purchase price is less than the issue price plus the accrued

OID ($96,813), the investor has market discount of $900 ($96,813–$95,913). The remaining OID on the obligation is $3,187 ($100,000–$96,813), which will be included in the investor's taxable income during the period the bonds are held and will increase his/her basis in the bonds. If the bonds are held until maturity, the investor will include the $900 of market discount in taxable income as ordinary interest income at that time.

Example:
Using the prior example, assume that the bonds are instead issued by State Z. The remaining OID of $3,187 is tax-exempt interest and will increase the investor's basis in the bonds as it accrues. As in the prior example, if the bonds are held until maturity, the investor will include the $900 of market discount in taxable income as ordinary interest income at that time.

Investors are limited in the amount of interest expense they are able to currently deduct on indebtedness incurred to purchase or carry an obligation with market discount. A taxpayer is able to deduct the "net direct interest expense" only to the extent that it exceeds the amount of accrued market discount on the obligation for the period it is held by the taxpayer during the taxable year.

With respect to any market discount bond, net direct interest expense is the amount of interest expense incurred by the taxpayer in excess of all interest income (including OID) includible in the taxpayer's gross income for the taxable year from that bond. Any disallowed interest expense will be deductible in the year the taxpayer disposes of the bond. An investor may elect, on an obligation-by-obligation basis, to deduct the deferred interest expense in a year in which there is net interest income (in excess of interest expense) on the obligation.

An investor may avoid the limitation on interest expense deductions by electing to include market discount currently in income during each taxable year. This election must be made for all market discount bonds held at the time of the election or subsequently acquired.

There are no similar provisions disallowing interest expense deductions on debt-financed OID obligations. However, interest expense on debt incurred to carry OID obligations is subject to the investment interest limitation rules (see page 32). The investment interest limitation also applies to interest expense on debt-financed market discount obligations, after the application of the disallowance rule.

Short-Term Obligations

Discount on short-term obligations is not included as income by individual investors until the obligation is disposed or paid at maturity. For this purpose, an obligation is short-term if the period from issue date to maturity is one year or less. Any gain on disposition is treated as ordinary interest income to the extent of the ratable share of the discount for the period the taxpayer has held the short-term obligation. Any excess gain or any loss realized is short-term.

If a short-term obligation held by an individual investor is financed, under rules similar to those applying to market discount bonds, the net direct interest expense is deferred until the discount is taken into income by the taxpayer (i.e., at disposition or maturity). A taxpayer may avoid this limitation by electing to include discount currently on all short-term obligations held.

These rules apply with respect to both OID on short-term non-governmental obligations and "acquisition discount" on short-term governmental obligations (such as Treasury bills). Acquisition discount is the difference between the stated redemption price at maturity and the taxpayer's basis in the obligation.

Amortizable Bond Premium

Bond premium is the amount paid for a bond in excess of its face value. The premium effectively reduces the yield on the bond. In the case of taxable

bonds, a taxpayer may elect to amortize the bond premium over the remaining life of the bond. This election is binding for all taxable bonds held or acquired in the first year to which the election applies or in subsequent years.

The premium is amortized on an economic accrual basis (for obligations issued after September 27, 1985). Such amortizable premium is applied against and reduces the interest income on the bond. A taxpayer's basis in the bond is decreased to reflect the premium so applied. In the case of tax-exempt bonds, the premium (which must be amortized) is not deductible, but basis is reduced by the amount of the amortized bond premium.

Convertibles and Exchangeables

The conversion of bonds into stock of the same issuer is generally not a taxable transaction. The stock received will have the same holding period and basis as the converted bonds. Any unaccrued OID will not be recognized. Accrued market discount at the time of the conversion will be recognized when the stock received is disposed. In contrast, the exchange of debt obligations of one issuer for debt obligations or stock of another issuer will generally be a taxable transaction.

A detailed discussion of the taxation of "hybrid instruments" ostensibly in debt form is beyond the scope of this booklet. However, it is the subject of active consideration by the Treasury Department and Internal Revenue Service. The use of these instruments continues to evolve, as do the tax rules that apply.

Conversion Transactions

For transactions entered into after April 30, 1993, the Internal Revenue Code re-characterizes as ordinary income certain amounts that would otherwise be considered capital gain (short-term or long-term) which arise from a "conversion transaction." In a conversion transaction, the investor is in the economic position of a lender — the investor has an expectation of a return from the transaction that in substance is in the nature of interest and undertakes no significant risks other than those typical of a lender. A conversion transaction is a transaction for which substantially all of an investor's return is attributable to the time value of the net investment and the investor (1) bought property and, at the same time, agreed to sell the same or substantially identical property for a higher price in the future; (2) created a "straddle" of actively traded property (see page 13); or (3) entered into a transaction that was marketed or sold as producing capital gain. Also, the Treasury Department is authorized to issue regulations in the future describing other transactions it will treat as conversion transactions subject to these rules.

In general, the amount of gain re-characterized as ordinary income will not exceed the amount determined by applying 120% of the appropriate applicable Federal interest rate to the investor's net investment in the conversion transaction.

While the application of this provision to the taxation of investments by individuals is currently unclear pending the issuance of official Treasury guidelines, the legislative history of this section suggests the following:

- Buying stock and writing an option where there is no substantial certainty that the holder of the option will exercise the option (e.g., long the stock, short an out-of-the-money call on the stock) is not a conversion transaction.
- An investor's net investment in a conversion transaction is the total amount invested less any amount received by the investor for entering into any position as part of the overall conversion transaction – for example, the receipt of option premium in granting an option.

■ In determining an investor's net investment in a conversion transaction, the source of the investor's funds generally will not be taken into account. Thus, if an investor purchased stock for $1000 but borrowed $900, the net investment would still be $1000.

■ Amounts that a taxpayer may be committed to pay in the future, (e.g., through a futures contract) generally will not be treated as an investment until such time as the amounts are in fact committed to the transaction and are unavailable to invest in other ways. A margin "deposit" is not viewed as an investment.

Example:

On January 4, 2000, an investor enters into a long futures contract committing the investor to purchase a certain quantity of gold on March 1 for $10,000. Also on January 4, the investor enters into a short futures contract to sell the same quantity of gold on April 1 for $10,060. The investor makes the required margin deposit. On February 1, both contracts are terminated for a net profit of $20. No part of that $20 is subject to re-characterization because the investor has no investment in the transaction on which the $20 could be considered an interest equivalent return.

Investment Income and Other Investment Expenses

Subject to the application of the anti-straddle rules (see page 13), an individual investor may currently deduct interest on debt incurred to purchase or carry investment property ("investment interest") in an amount equal to the individual's net investment income. Investment interest paid during the year that exceeds the limitation may be carried forward and may be deducted in future years (subject to the limitation applicable in that year).

Margin interest, otherwise deductible short sale expenses and amortizable bond premium with respect to premium obligations acquired after October 22, 1986 are examples of investment interest. Net investment income does not include net capital gain (net long-term capital gain minus net short-term capital loss). An investor can elect to include in investment income so much of his/her net capital gain as he/she chooses, but the amount of net capital gain eligible for the 20% capital gain rate must be reduced by the same amount. Net short-term capital gains are included in investment income.

Itemized deductions for investment advisory, custody and trust administration fees, subscriptions to investment advisory publications and similar expenses of producing income (other than trade or business expenses) are limited. Such "miscellaneous itemized deductions" and certain employee business expenses are deductible only to the extent that, in the aggregate, they exceed 2% of the taxpayer's adjusted gross income. However, certain expenses deductible as miscellaneous itemized deductions are not subject to the 2% floor. These include bond premium amortization and short-sale expenses.

Individuals whose adjusted gross income is over an inflation adjusted dollar amount will have most of their itemized deductions reduced by 3% of the adjusted gross income over that amount. In 2000, that number is $128,950 ($64,475 for married taxpayers filing separately). Investment interest expense (such as margin account interest) is not included as an itemized deduction for purposes of this deduction limitation. In no event are total otherwise allowable itemized deductions (excluding those not covered by the new rules) reduced by more than 80% as a result of this limitation. This limitation is applied after the application of the 2% floor and impacts regular tax but not the alternative minimum tax.

Appendix I

In-the-Money Qualified Covered Calls For Stock Priced $25 or Less

Applicable Stock Price ($)	Strike Price ($)
5.01 to 5.88	5
5.89 to 7.50	None
7.51 to 8.82	7.50
8.83 to 10.00	None
10.01 to 11.76	10
11.77 to 12.50	None
12.51 to 14.70	12.50
14.71 to 15.00	None
15.01 to 17.64	15
17.65 to 20.00	17.50
20.01 to 22.50	20
22.51 to 25.00	22.50

Appendix II

Taking into account proposed and temporary Treasury regulations on offsetting positions, the following chart represents the current opinion of Ernst & Young LLP as to the treatment of the described transactions for Federal income tax purposes. The opinion of Ernst & Young LLP is not binding upon the Internal Revenue Service and, accordingly, no assurance can be given that the Service will not challenge the opinion and, if challenged, that such opinion would be upheld.

Final regulations may be issued by the Internal Revenue Service in the future which may result in tax treatment contrary to the conclusions set forth below. In particular, Treasury guidance with respect to the application of the constructive sale rule to option transactions, when issued, may significantly impact the tax treatment described in this Appendix II.

Investors are strongly advised to consult their tax and legal advisors in considering the tax consequences of their own specific circumstances.

Effects of Various Strategies

	Positions	Effect on Holding Period	Deferral of Loss (1)	Capitalization of Interest and Carrying Charges
1.	**Long Stock-Short Stock** (substantially identical)	**(2)**	**(2)**	No
2.	**Long Stock-Short Stock** (not substantially identical)	No Effect	No	No
3.	**Long Stock-Short Call** (not qualified call)			
a.	**stock held:** short-term	Terminate	Yes	Yes
b.	**stock held:** long-term	**(3)**	Yes	Yes
4.	**Long Stock-Short At-the-Money or Out-of-the-Money Qualified Covered Call**			
a.	**long stock:** gain or loss position **time of writing call:** not relevant **call closed:** same year as stock disposed, gain or loss on call not relevant	No Effect	No	No
b.	**long stock:** gain position **time of writing call:** not relevant **call closed:** at loss, year preceding disposition of stock **days stock held after call closed:** less than 30 days **(4)**	No Effect	Yes	No

continued on following page

	Positions	Effect on Holding Period	Deferral of Loss (1)	Capitalization of Interest and Carrying Charges
c.	**long stock:** gain position **time of writing call:** not relevant **call closed:** at loss, year preceding disposition of stock **days stock held after call closed:** 30 days or more **(4)**	No Effect	No	No
d.	**long stock:** loss position **time of writing call:** not relevant **call closed:** at gain, year preceding disposition of stock **days stock held after call closed:** not relevant	No Effect	Not Applicable	No
e.	**long stock:** loss position **time of writing call:** not relevant **call closed:** at gain, year subsequent to disposition of stock **days option held after stock sold:** less than 30 days **(4) (9)**	No Effect	Yes	No
f.	**long stock:.** loss position **time of writing call:** not relevant **call closed:** at gain, year subsequent to disposition of stock **days option held after stock sold:** 30 days or more **(4) (9)**	No Effect	No	No
5.	**Long Stock-Short In-the-Money Qualified Covered Call**			
a.	**long stock:** gain or loss position **time of writing call:** stock held long-term **call closed:** same year as stock disposed, gain or loss on call not relevant	**(3)**	No	No

	Positions	Effect on Holding Period	Deferral of Loss (1)	Capitalization of Interest and Carrying Charges
b.	**long stock:** gain or loss position **time of writing call:** stock held short-term **call closed:** same year as stock disposed, gain or loss not relevant	Suspend	No	No
c.	**long stock:** gain position **time of writing call:** stock held long-term **call closed:** at loss, year preceding disposition of stock **days stock held after call closed:** less than 30 days **(4)**	**(3)**	Yes	No
d.	**long stock:** gain position **time of writing call:** stock held long-term **call closed:** at loss, year preceding disposition of stock **days stock held after call closed:** 30 days or more **(4)**	**(3)**	No	No
e.	**long stock:** gain position **time of writing call:** stock held short-term **call closed:** at loss, year preceding disposition of stock **days stock held after call closed:** less than 30 days **(4)**	Suspend	Yes	No
f.	**long stock:** gain position **time of writing call:** stock held short-term **call closed:** at loss, year preceding disposition of stock **days stock held after call closed:** 30 days or more **(4)**	Suspend	No	No
g.	**long stock:** loss position **time of writing call:** stock held long-term **call closed:** at gain, year preceding	No Effect	Not Applicable	No

continued on following page

	Positions	Effect on Holding Period	Deferral of Loss (1)	Capitalization of Interest and Carrying Charges
	disposition of stock **days stock held after call closed:** not relevant			
h.	**long stock:** loss position **time of writing call:** stock held short-term **call closed:** at gain, year preceding disposition of stock **days stock held after call closed:** not relevant	Suspend	Not Applicable	No
i.	**long stock:** loss position **time of writing call:** stock held long-term **call closed:** at gain, year subsequent to disposition of stock **days option held after stock sold:** less than 30 days **(4) (9)**	No Effect	Yes	No
j.	**long stock:** loss position **time of writing call:** stock held long-term **call closed:** at gain, year subsequent to disposition of stock **days option held after stock sold:** 30 days or more **(4) (9)**	No Effect	No	No
k.	**long stock:** loss position **time of writing call:** stock held short-term **call closed:** at gain, year subsequent to disposition of stock **days option held after stock sold:** less than 30 days **(4) (9)**	Suspend	Yes	No
l.	**long stock:** loss position **time of writing call:** stock held short-term **call closed:** at gain, year subsequent to disposition of stock **days option held after stock sold:** 30 days or more **(4) (9)**	Suspend	No	No

	Positions	Effect on Holding Period	Deferral of Loss (1)	Capitalization of Interest and Carrying Charges
6.	**Long Stock-Short Put**	No Effect	No	No
7.	**Short Stock-Short Put**	Not Applicable	Yes **(5)**	Yes **(5)**
8.	**Long Call-Short Call**	Terminate	Yes	Yes
9.	**Long Call-Long Put**	Terminate	Yes	Yes
10.	**Long Call-Short Stock**	Terminate	Yes	Yes
11.	**Long Call-Short Put**	Terminate **(5)**	Yes **(5)**	Yes **(5)**
12.	**Long Put-Short Put**	Terminate	Yes	Yes
13.	**Long Put-Short Call**	Terminate **(5)**	Yes **(5)**	Yes **(5)**
14.	**Short Call-Short Put**	Not Applicable	Yes **(5)**	Yes **(5)**
15.	**Long Put-Short Stock**	No Effect	No	No
16.	**Long Stock-Long Put** (“married put”)	**(6)**	**(6)**	**(6)**
17.	**Long Stock-Long Put** (not “married put” or “divorced” married put)			
a.	**stock held:** short-term	Terminate	Yes	Yes
b.	**stock held:** long-term	**(7)**	Yes	Yes
18.	**Long Portfolio of Stock-Short Broad U.S. Stock Index Future** (“mimic”) **(8)**	Terminate	Yes	Yes
19.	**Long Portfolio of Stock-Short Call on Broad U.S. Stock Index** (“mimic”) **(8)**	Terminate	Yes	Yes
20.	**Long Portfolio of Stock-Short Call on Broad U.S. Stock Index Future** (“mimic”) **(8)**	Terminate	Yes	Yes

continued on following page

	Positions	Effect on Holding Period	Deferral of Loss (1)	Capitalization of Interest and Carrying Charges
21.	**Long Portfolio of Stock-Short Broad U.S. Stock Index Future** (not "mimic") **(8)**	No Effect	No	No
22.	**Long Portfolio of Stock-Short Call on Broad U.S. Stock Index** (not "mimic") **(8)**	No Effect	No	No
23.	**Long Portfolio of Stock-Short Call on Broad U.S. Stock Index Future** (not "mimic") **(8)**	No Effect	No	No

Notes

1. When there are offsetting positions in a straddle, losses realized on the closing of a position in one year are deferred to the extent of the unrecognized gain in "offsetting positions" to the loss position, "successor positions" and offsetting positions to the successor positions. The deferred loss is recognized by the taxpayer in a subsequent year. Investors must also take into account the impact of the wash sale and constructive sale rules on transactions involving offsetting positions.

2. Where the offset to the appreciated position (whether the "long stock" or the "short stock") is entered into after June 8, 1997, the constructive sale rule generally applies. Subject to certain exceptions, gain is recognized as if the position were sold at its fair market value on the date of sale and immediately repurchased. The basis of the appreciated position is increased by any gain realized, and a new holding period begins as if the position had been acquired on the date of the constructive sale.

3. If the stock is held long-term at the time the call is written, any loss will be deemed a long-term capital loss, regardless of when recognized.

4. Only days on which the stock is held with no offsetting position will generally be counted. However, the holding period continues to run while the investor is the writer of qualified covered calls.

5. This is based on the assumption that the premium received constitutes a substantial diminution of risk of loss. That may not, however, be the case. If there is no substantial diminution of risk of loss, there would not be offsetting positions and the anti-straddle rules would not apply.

6. Temporary Treasury regulations suggest that the married put exception may not apply. If the married put exception does not apply, see item "17." However, if married puts are exempt from the anti-straddle rules, there is no effect on holding period; also, there may be no deferral of losses and no capitalization of interest and carrying charges. Further Treasury clarification is required.

7. Loss on the put will be long-term, regardless of holding period.

8. When the performance of a portfolio of stocks "mimics" the performance of stocks contained in a stock index, offsetting positions in the portfolio of stocks and in instruments based on that index will be subject to the anti-straddle (including the loss deferral) rules. The performance of a basket of stocks "mimics" the performance of a stock index where changes in the fair market value of the basket of stocks "approximate," directly or indirectly, changes in the fair market value of the index. Treasury regulations provide an objective mechanical test to determine the amount of overlap between the portfolio and the index and the extent to which the anti-straddle rules apply.

9. This rule applies to positions established after December 31, 1986.

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Addendum

On page 4, please add before the last paragraph:

Beginning in 2001, the 20% long-term capital gain rate is reduced to 18% on capital assets (subject to certain exceptions) held for more than 5 years (and the 10% capital gain rate for taxpayers in the 15% tax bracket is reduced to 8%). Capital assets purchased before January 1, 2001 are not generally eligible for the 18% rate. (No similar requirement applies to the 8% rate.) However, an election may be made to treat a capital asset held on January 1, 2001 as if it had been sold at fair market value on January 2, 2001 and re-acquired on that date.

On page 4, please add after the last paragraph:

The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Act") includes the following relevant provisions:

- Beginning July 1, 2001, the 2001 Act reduces the top marginal tax rate from 39.6% to 35%, phased in over a five-year period. For calendar year 2001, the blended top rate is 39.1%. Other individual income tax rates will also be gradually reduced, in addition to the creation of a new 10% tax rate bracket.
- Currently, certain itemized deductions and personal exemptions are phased out when income exceeds certain thresholds. The 2001 Act repeals these phase-outs over five years, beginning in 2006.

On page 34, please substitute the following information for the ninth and tenth lines:

Applicable Stock Price ($)	Strike Price ($)
15.01 to 17.50	15
17.51 to 20.00	17.50