Ways and Means Committee Issues Draft Provisions to Reform Taxation of Financial Instruments

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On January 24, 2013, the Chairman of the House Ways and Means Committee (the “Committee”) released a Tax Reform Proposal on Financial Instruments (the “Draft”). The Draft would do the following: (1) Provide Uniform Tax Treatment of Financial Derivatives; (2) Simplify Business Hedging Tax Rules; (3) Eliminate "Phantom" Tax Resulting from Debt Restructurings; (4) Harmonize the Tax Treatment of Bonds Traded at a Discount or Premium on the Secondary Market; (5) Increase the Accuracy of Determining Gains and Losses on Sales of Securities; and (6) Prevent the Harvesting of Tax Losses on Securities.

Some of the provisions in the Draft are revolutionary, while others are more of a technical nature. Specifically, the proposed mark-to-market treatment for derivatives and the harmonization of the original issue discount and market discount, if adopted, would significantly change the current landscape with respect to taxation of financial instruments. This author proposed in 2007 to adopt mark to market rules for derivatives on a comprehensive basis. Several other commentators have expressed similar views. Apparently, Congress has listened.

History and Stated Reason for Change

Since the 2008 financial crisis, Congress has considered on several occasions the reform of the taxation rules applicable to financial instruments. This was mostly driven by Congress’s belief that the rapid growth and abuse of financial instruments such as derivatives contributed to the crisis. Congress also partially “blamed” the inconsistent and incoherent tax rules governing derivatives and other financial products as a factor contributing to tax shelters. Thus, reforming the taxation rules for financial instruments became a priority on Capitol Hill.

On December 6, 2011, a joint hearing of the Senate Finance Committee examined the tax treatment of financial products. Based on testimony received during this hearing and input from tax practitioners, experts and commentators such as the American Bar Association Tax Section, the Committee released the previous discussion draft of proposals to reform the tax treatment of financial products. The current Draft continues the momentum.

The Draft follows the October 26, 2011, discussion draft on international tax reform. According to the Committee, this Draft, in conjunction with the discussion draft on international reform, would be part

of comprehensive tax reform legislation that is intended to broaden the base, lower rates, and move the United States to a more economically competitive tax system on a revenue-neutral basis.

Mark-to-Market Treatment of Derivatives

General

The Draft would require taxpayers engaged in "speculative" financial activity (as opposed to hedging) to mark certain derivative positions to market, thus triggering the recognition of gain or loss for tax purposes. Current rules already require or permit mark-to- market accounting for specific financial products, such as certain contracts and options that are traded on exchanges (under section 1256 of the Internal Revenue Code of 1986, as amended, or the "Code"), and for specific taxpayers, such as securities and commodities dealers and traders (pursuant to section 475). However, current mark-to-market treatment for derivatives is very limited. The proposed rules would not apply to any derivative that is part of a hedging transaction (as defined in section 1221). According to the Committee, "[b]roadly extending mark-to-market accounting treatment to derivatives would provide a more accurate and consistent method of taxing these financial products and make them less susceptible to abuse, without affecting most small investors who normally do not invest in these products."

Overview of the Proposed Rule

Gain or loss from derivatives would generally be recognized under a mark-to-market rule, and such gains or losses would be treated as ordinary. The character provision is critical because many derivatives that have been subject to the so called 60/40 rule (under section 1256) would now be taxed as ordinary.[1] In addition, the mark-to-market gains and losses would be treated as attributable to a trade or business of the taxpayer.

Mark-to-market and ordinary treatment would also apply to the termination or transfer of a taxpayer's rights or obligations with respect to a derivative. Such termination or transfer is broadly defined to include offsetting, taking or making delivery, exercise or being exercised, assignment or being assigned, lapse, expiration, settlement, or otherwise. As a result, current inconsistent rules pertaining to the character of terminations or transfer would also be simplified with this ordinary-treatment rule.

Fair Market Value

Determination of fair market value has always been a big obstacle for broader adoption of a mark–to-market regime in the U.S. Adoption of the proposed rule obviously would require fair market value determinations for the taxpayer's derivative positions. If the value is not readily ascertainable, it would be determined under the method used by the taxpayer in reports to shareholders, partners, other proprietors, beneficiaries, or as used for purposes of obtaining credit. Fair market value would be determined without regard to any premium or discount related to the relative size of the taxpayer's position to the total available trading units of an instrument.

Definition of Derivative

A "derivative" would be defined as (1) any evidence of an interest in, or any derivative instrument with respect to, any (a) share of stock in a corporation, (b) partnership interest or beneficial ownership interest in a partnership interest or trust, (c) note, bond, debenture, or other evidence of indebtedness, (d) certain real property, (e) actively traded commodity, or (f) currency; (2) any notional

principal contract; and (3) any derivative instrument with respect to any interest or instrument described above. The definition is intended to be broad in several aspects. It includes options, forwards or futures with respect to any stock, partnership interest or debt regardless of whether the contract or interest (or the underlying contract or interest) is privately held or publicly traded. It also includes short sales and short securities futures contracts.

Notional principal contracts (NPCs) are also included. An NPC for this purpose is any instrument requiring two or more payments at specified intervals calculated by reference to a specified index upon one or more notional amounts. An amount will not fail to be treated as a "payment" for this purpose merely because the amount is fixed on one date but paid (or otherwise taken into account) on a different date. A "specified index" for this purpose would be any one or more of (or a combination of) (1) a rate, price or amount (whether fixed or variable); (2) any index based on any information that is not in the control of any of the parties to the instrument and not unique to any of the parties' circumstances; and (3) any other index as determined under Regulations.

The Committee noted that the definition of NPC is broader than the definition under Treasury regulations 1.446-3. For example, the definition of a specified index includes indices other than those based on objective financial information, such as temperature, precipitation, snowfall, or frost. Such indices have been confirmed by Treasury to be specified indices in recent proposed Treasury Regulations under sections 446 and 1256.[2]

The Draft also discussed credit default swaps (CDSs). A CDS is a contractual arrangement in which one party buys from another party protection against default by a particular obligor with respect to a particular obligation. CDSs have been analogized to notional principal contracts or contingent put options (as well as guarantees or insurance). The Draft would treat CDSs as derivatives. Again, this approach is consistent with the recently proposed Regulations under sections 446 and 1256, which, for the first time, specifically included CDSs in the definition of NPCs.

Under the Draft, a "derivative" would also include any embedded derivative component of a debt instrument. An embedded derivative for this purpose means any term of a debt instrument that affect some or all of the cash flows or the value of other payments on the instrument in a manner similar to a derivative. A common example is convertible debt. The Draft would treat convertible debt as two instruments, non-convertible debt (not subject to the mark-to-market rule) and an option to acquire stock of the issuer (subject to mark-to-market). This proposed rule is in contrast to the traditional treatment of a convertible debt as a single instrument for tax purposes. To implement this rule, however, revisions to the OID rules (which currently do not allow separate treatment to the conversion feature) will be necessary. In the author's view, the biggest problem with this proposal will be the valuation of the embedded option.

Exclusion for Certain Derivatives on Real Estate

An interest or instrument will not be treated as a "derivative" if it is either (1) with respect to a tract of real property as defined in section 1237(c), or (2) with respect only to real property which would be inventory if held directly by the taxpayer.

Mixed Straddles

The mark-to-market and ordinary treatment rules would apply to all positions in a straddle (generally offsetting positions with respect to personal property) even if these positions are not otherwise marked to market (i.e., a "mixed straddle").[3] If the position would have a built-in gain, it would be

treated as sold for its fair market value at the time of entering the straddle. If the position, however, would have a built-in loss, it would not be treated as sold at the time of entering the straddle; instead, the amount of the built-in loss would be taken into account in determining the amount of gain or loss when the position is disposed of in a transaction in which gain or loss is otherwise recognized.

Simplifying the Hedging Rules

Under the Draft, a hedging transaction would be treated as meeting the requirements of section 1221 (as a tax hedging transaction) if it is identified as a hedging transaction for tax purposes (as required under existing law), or if the transaction is treated as a hedging transaction within the meaning of GAAP for purposes of the taxpayer's audited financial statement.[4] The financial statement must be certified as being prepared in accordance with GAAP by an independent auditor and must be used for the purposes of a statement or report to shareholders, partners, or other proprietors, or to beneficiaries, or for credit purposes. A transaction treated as a hedging transaction for GAAP purposes would be treated as a hedging transaction for tax purposes if it met the substantive definition of a tax hedging transaction, which is unchanged by the Draft. According to the Committee, "[t]his taxpayer-favorable proposal would minimize inadvertent failures to identify a transaction as a hedge for tax purposes, even though the transaction satisfies all of the substantive requirements for hedging transaction tax treatment."

Excluding COD Income in Certain Debt Restructurings

The Draft would reform the tax rules that apply to debt restructurings that do not involve a forgiveness of principal. This welcome change would eliminate COD income when debt is restructured. Specifically, in the case of any "specified debt modification" (defined below), the issue price of the modified debt instrument would be the lesser of (i) the adjusted issue price of the existing debt instrument or (ii) if the debt instrument were a debt instrument to which section 1274 applied (i.e., the principal amount if there is adequate stated interest or, otherwise, the imputed principal amount), the issue price of the modified debt instrument would be determined under section 1274. As a result, if the principal amount of the debt does not change, the debt modifications will not cause the issuer to recognize COD income. This is clearly a needed provision considering the growing number of distressed debt restructurings.

A "specified debt modification" means (i) an exchange by the issuer of a new debt instrument for an existing debt instrument of the issuer or (ii) the amendment of an existing debt instrument, including a significant modification of an existing debt instrument which is accomplished by the issuer and the holder indirectly through one or more transactions with unrelated parties.

Example

A publicly traded debt instrument with a redemption price and an adjusted issue price of $10,000 is exchanged for a new debt instrument with a redemption price of $10,000 (and adequate stated interest) with an extended maturity; the issue price of the new debt is $10,000 regardless of the fair market value of the old debt. Thus, the issuer will not have any COD income.

Harmonize the Tax Treatment of Bonds Traded at a Discount or Premium on the Secondary Market

Under current law, absent an election, the holder can include in income the market discount only

upon the disposition of the bond. In contrast OID is includible in income of the holder on a current basis, using a constant interest rate. The Draft would require the holder of a market discount bond to recognize taxable income on the discount over the remaining life of the bond, thereby harmonizing the tax treatment of such instruments to bonds acquired at original issue discount (OID). A holder of a market discount bond acquired after December 31, 2013 would include in gross income on a current basis the sum of the daily portions of the market discount for each day during the taxable year that the taxpayer holds the bond. The income inclusion would be computed on the basis of a constant interest rate, similar to the OID principles. The amount included would generally be treated as interest. However, the amount of market discount to be recognized would be limited to the discount that typically reflects an increase in interest rates that has occurred since the date the bond was originally issued, as opposed to deeper discounts that often reflect deterioration in the creditworthiness of the borrower.

Thus, for the first time, a distinction between “normal” market discount (arising as a result of interest rate reduction) and distressed debt market discount has been acknowledged by Congress. Specifically, to determine what would be a “normal” discount, the Draft provides that the amount of discount includible will not exceed the amount that would be so includible if the basis of the bond immediately after its acquisition was the imputed principal amount determined by using a discount rate equal to the greater of (i) an amount equal to the bond’s yield to maturity (as of the issue date) plus 5% or (ii) an amount equal to the applicable Federal rate for the bond (at the time of acquisition) plus 10%. Thus, the interest includible in income cannot exceed the greater of the amounts determined above based on the acquisition price.

The Draft also would allow taxpayers to claim “above-the-line” deductions for bonds acquired at a premium on a secondary market and repeal the special rules for short-term non-governmental obligations held by taxpayers subject to current inclusion, which require the accrual of original issue discount but not market discount.

Example

On January 1, 2014, XYZ Corporation issues a $1,000 10-year publicly-traded bond with a 5% coupon, with $50 of interest paid annually on December 31 of each calendar year. The bond is issued for $960, with OID of $40. Bondholders accrue OID based on the bond’s yield to maturity at issuance.84 XYZ Corporation deducts this amount of OID over the life of the bond. The annual yield to maturity at the time the bond is issued is 5.53%.

On January 1, 2016, Taxpayer buys the bond in the secondary market for $950. In addition to OID, Taxpayer accrues market discount under the provision based on the calculated annual yield to maturity for the bond based on Taxpayer’s adjusted basis of $950, which is 5.80 percent.

On December 31, 2016, Taxpayer has income of $55.09 ($950 multiplied by .0580), of which $50 represents stated interest, $3.45 represents accrued original issue discount, and $1.64 represents accrued market discount. The accrued OID and accrued market discount are added to the basis of the bond. For 2016, Taxpayer has total ordinary income of $55.09 and adjusted basis of $955.09.

Increase the Accuracy of Determining Gains and Losses on Sales of Securities

To simplify tax compliance and administration, and to determine more accurately the amount of gain or loss when a security is sold, the Draft would require the cost basis of the security to be based on the average cost basis of all other shares or units of the identical security held by the taxpayer. The

cost of any specified security sold, exchanged, or otherwise disposed of on or after January 1, 2014, would be determined in accordance with the average basis method (currently permitted only for RIC stock).

The Draft would treat any specified security that is acquired before January 1, 2014, as in a separate account from any security that that is acquired on or after that date. Accordingly, a taxpayer would determine the basis of any specified security acquired in 2014 or later by disregarding the basis of specified securities acquired before 2014. Basis would be determined on an account-by-account basis, so that if a taxpayer owns specified securities in more than one account, basis computations are made separately for securities in each account.

Wash Sales and Related Parties

The "wash sale" rule is intended to prevent taxpayers from taking tax losses by selling securities at a loss and then immediately reacquiring the same securities. Under section 1091, in general, a taxpayer may not deduct losses from the disposition of stock or securities if "substantially identical" stock or securities (or an option to acquire such property) are acquired by the taxpayer during the period beginning 30 days before the date of sale and ending 30 days after such date of sale. The current wash sale rule only applies if the same taxpayer sells and reacquires the security. The Draft would reform the wash sale rule so that it would apply to transactions involving closely related parties. The Draft, therefore, expands the application of the wash sale rules to acquisition of substantially identical stock or securities by the taxpayer or a related party. Furthermore, the basis of the substantially identical stock or securities would not be adjusted to include the disallowed loss in the case of any acquisition by a related party other than the taxpayer's spouse.

For this purpose, a related party means: (1) the taxpayer's spouse; (2) any dependent of the taxpayer and any other taxpayer with respect to whom the taxpayer is a dependent; (3) any individual, corporation, partnership, trust, or estate that controls, or is controlled by the taxpayer or any individual described in (1) or (2); (4) any individual retirement arrangement (IRA), Archer MSA, or health savings account of the taxpayer or of any individual described in (1) or (2); (5) any account under a qualified tuition program or a Coverdell education savings account if the taxpayer or any individual described in (1) or (2) is the designated beneficiary of such account or has the right to make any decision with respect to the investment of any amount in such account; and (6) any account under a qualified retirement plan, qualified annuity plan, tax-sheltered annuity plan, or governmental eligible deferred compensation plan, if the taxpayer or any individual described in (1) or (2) with respect to the taxpayer has the right to make any decision with respect to the investment of any amount in such account.

Concluding Remarks

The stated goals of the Draft are threefold. The Committee has stated that the Draft would update antiquated tax rules that have not kept pace with innovation in the financial-products market (e.g., market discount and OID rules), and would also make significant changes to the way the United States taxes financial products (e.g., mark-to-market). In addition, the proposed changes are said to be broadening the tax base and are expected to raise revenues. In the author's view, while the substantive proposed changes are welcome, the revenue impact of these changes is far from clear. Time will tell if expanding the mark-to-market rules to apply to more derivatives will raise more revenues.

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1 Section 1256 provides mark-to-market rules for certain types of contracts identified as a "section 1256 contract. The character of gain or loss of a

section 1256 contract is treated as long-term capital gain or loss, to the extent of 60 percent of the gain or loss, and short-term capital gain or loss, to the extent of the remaining 40 percent of the gain or loss regardless of the taxpayer’s holding period.

2 On September 16, 2011, the Treasury and IRS issued proposed regulations under sections 1256 and 446 of the Code , which, if adopted, would affect the scope of the term “section 1256 contract” and revise the scope of the notional principal contract regulations under section 446.

3 Pursuant to section 1092(b)(2), if a straddle consists of positions that are section 1256 contracts and positions that are not, the taxpayer may designate the straddle as a mixed straddle. Positions in a mixed straddle are generally not subject to the mark-to-market rule.

4 Under section 1221(b)(2)(A), a hedging transaction is any transaction entered into by the taxpayer in the normal course of the taxpayer’s trade or business primarily to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer,

to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred

or to be incurred, by the taxpayer, or to manage other risks as prescribed under Treasury regulations.

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