



House Ways and Means Committee Releases Draft Provisions to Reform Financial Instruments Taxation

January 30, 2013

EXECUTIVE SUMMARY

On January 24th the House Ways and Means Committee, chaired by Dave Camp (R – Mich.), issued “Discussion Draft Provisions to Reform the Taxation of Financial Instruments” (the “Draft”). The Draft calls for certain changes to Internal Revenue Code¹ provisions relating to financial instruments. The proposals are broad and would affect holders of derivatives, as well as many capital markets and restructuring transactions. The most significant changes proposed by the Draft includes proposals that would:

- Require all derivative positions to be marked to market on an annual basis, requiring ordinary gain or loss to be recognized. “Derivative” would be defined broadly and would include positions in a straddle that include derivatives, even if all such positions are not themselves derivatives;
- Eliminate phantom cancellation of indebtedness (“COD”) income to issuers resulting from debt restructurings by changing the way in which “issue price” is determined in these circumstances, which proposal could also result in phantom gain recognition for secondary market purchasers of distressed debt that is later modified;
- Require secondary market purchasers to currently include accrued market discount in income up to a certain threshold, but exempt any market discount above such threshold from the market discount rules; and
- Require cost basis for securities to be determined using an average basis method, eliminating taxpayers’ ability to identify the securities sold.

The provisions contained in the Draft are generally applicable for transactions occurring after December 31, 2013. Below is a brief discussion of the Draft’s key proposals.

MARK-TO-MARKET TREATMENT OF FINANCIAL DERIVATIVES

New section 485 would provide that “any derivative held by a taxpayer at the close of the taxable year shall be treated as sold for its fair market value on the last business day of such taxable year,” with any gain or loss to be taken into account for such year as ordinary income or loss. Adjustments are then to be made for purposes of gains and losses subsequently realized

¹ All “section” references are to the Internal Revenue Code of 1986, as amended.

on such derivatives. Where a straddle includes at least one derivative position, all positions making up the straddle would be subject to mark-to-market treatment. Special rules apply to built-in-gain and loss positions that become part of a straddle. Section 1256, under which regulated futures contracts are subject to 60%/40% long term/short term capital gain or loss on a mark-to-market basis, would be repealed.

The term “derivative” includes any evidence of an interest in corporate stock, partnership interests, debt, commodities, real estate (subject to certain exceptions) and currencies. It also includes any notional principal contracts and any options, futures contracts, forward contracts, short positions or swaps or “other financial instruments” with respect to the asset classes mentioned above. The definition of a “notional principal contract” for purposes of the Draft is broader than the definition in the current rules under section 446. Derivatives used by taxpayers to hedge against customary business risks such as currency and commodity prices (that is, hedging transactions as defined in section 1221(c)) would not be subject to the mandatory mark-to-market regime.

A derivative also includes an “embedded derivative component” of a debt instrument. An example of an embedded derivative component is the embedded option component of a convertible debt instrument. Under the Draft proposal, a convertible debt instrument would, for purposes of the mark-to-market rule, be bifurcated into a debt instrument not subject to mark-to-market tax accounting, and an embedded stock derivative subject to mark-to-market treatment.

The determination of fair market value in the case of a derivative for which such value is not readily ascertainable would be determined (under regulatory authority) based on the fair market value of the derivative reported by the taxpayer for financial or credit purposes. Moreover, value is to be determined without regard to any premium or discount attributable to the size of the taxpayer’s position.

ELIMINATING PHANTOM INCOME RESULTING FROM DEBT RESTRUCTURINGS

The Draft proposes to revise the manner in which the issue price of a debt instrument is determined in the case of “specified debt modifications.” In particular, a new section 1274B would provide that the issue price of the modified debt instrument would be equal to the lesser of (1) the adjusted issue price of the existing debt instrument, and (2) the issue price of the modified debt instrument which would be determined under section 1274 if the debt instrument were a debt instrument to which that section applied.

This provision of the Draft would have a significant impact on taxpayers who engage in debt exchanges and restructurings. Under current law, issuers commonly realize COD as a result of debt restructurings, even if they remain liable on debt whose principal amount has not changed. The Draft’s provision would generally result in no COD in a debt restructuring in which the issuer does not actually forgive any of the principal amount of the loan.

Moreover, although the Technical Explanation does not address the impact of this change to holders, under the Draft proposal, it appears that secondary market purchasers of distressed debt would recognize a current gain (with a potential capital loss upon disposition) when the debt is subsequently modified, assuming tax-free recapitalization treatment does not apply.

This is in contrast to current law, under which these holders would only recognize gain upon the subsequent modification where the fair market value of the debt exceeds their tax basis.

REQUIRE CURRENT INCLUSION OF MARKET DISCOUNT

The Draft contains a provision that would require a portion of market discount to be included currently on a constant yield basis. This proposal would conform the treatment of market discount to the treatment of original issue discount, which is subject to mandatory accrual and recognition under current law. The Draft places a cap on the amount of the market discount that must be included currently, which cap is intended to isolate the portion of the market discount that reflects an increase in market interest rates. This cap would be equal to the amount that would be includible under this rule if the basis of the debt instrument were the imputed principal amount using a discount rate equal to the greater of (1) the original yield to maturity of the debt instrument plus 5%, and (2) the applicable federal rate applicable to the debt instrument as of the date of its acquisition, plus 10%.²

This proposal changes the current law treatment of market discount, which, absent an election, is included by holders as ordinary income only upon disposition of the debt instrument. However, market discount in excess of the cap would not be subject to the market discount rules at all and would be treated as capital gain upon disposition.

Finally, the Draft contains a provision stating that in the case of a bond held by a partnership with respect to which there is a transfer of an interest described in section 743, the transferee partner may be required to accrue market discount.

AVERAGE COST BASIS REPORTING FOR SECURITIES

Under current law, where a taxpayer has acquired stock in a corporation on different dates or at different prices and sells some (but not all) of the shares, the taxpayer is able to select which securities are being “sold” when determining the amount of gain or loss recognized on the sale transaction. If a taxpayer did not identify a particular security, the first-in-first-out rule is used. The Draft contains a proposal that would require taxpayers to determine their gain or loss using an average basis method.

OTHER DRAFT PROPOSALS

The Draft contains several other proposals, including:

- Allowing amortizable bond premium as an above-the-line deduction under section 62(a)(8);

² The proposal also ensures that the holder’s basis is adjusted to reflect any market discount included in income, and that interest on debt incurred to carry a market discount bond is not deferred to the extent the market discount is included under the new provision.

- Simplification of the business hedging rules by allowing transactions that are properly being treated as hedges for financial accounting purposes to be treated as hedges for U.S. federal income tax purposes under section 1221; and
- Expanding the wash sale rules by treating the acquisition of the security by a related party (for example, a spouse, dependent, controlled entity or retirement or other managed account) as the acquisition by the taxpayer for purposes of determining whether the wash sale rules of section 1091 apply.

The Draft was issued in order to solicit input from tax professionals who deal with financial products issues. Camp noted that the complexity of the instruments being used in the financial sector makes it critical to have the insight of these individuals.

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