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Tax Reform – The Next Installment: Reforming the Taxation of Financial Instruments

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After the fiscal cliff deal[1] failed to include a framework for comprehensive tax reform, many in Washington predicted that the momentum for tax reform would wither away. Although Congress has many important issues on its agenda in the new session, including immigration and gun control, the House Ways and Means Committee's Discussion Draft to Reform the Taxation of Financial Instruments (the "Discussion Draft") keeps the discussion alive and shows that the reports of tax reform's death are greatly exaggerated.

The Discussion Draft has several notable characteristics:

- **What does it do?** The bill attempts to update the tax code to keep pace with rapid innovations on Wall Street by making the rules simpler, fairer and more transparent, while minimizing the potential for abuse. These rules include consistent mark-to-market treatment for derivatives and average basis reporting for the sale of securities.
- **What was left out?** The proposal does not completely revamp how the federal government taxes financial transactions and instruments. Several significant issues—including active financing, carried interest, debt versus equity financing and the deductibility of interest expense—were left out.
- **Tweaks, not wholesale changes.** Further, the issues that the proposal does address are reformed in a targeted way. Most of the proposal's changes are intended to increase transparency and change the timing of how income is taxed.
- **Tightening and loosening of tax rules.** The draft proposal tightens the tax treatment of financial instruments in some circumstances while loosening rules in others. The approach outlined in the proposal is consistent with the Committee's efforts to simplify the Internal Revenue Code (the "Code").
- **One piece of the puzzle.** The Ways and Means Committee released a draft international tax reform proposal in October 2011 that would move the United States to a territorial system. Like the international proposal, the draft on financial instruments represents just one piece of a larger puzzle to reform the federal tax system. As the 113th Congress moves forward, expect the Ways and Means Committee to release additional pieces of its tax reform positions in other substantive areas.

[1] American Taxpayer Relief Act of 2012 (Pub. L. 112-240).

- **Feedback is welcome, but act fast.** The Ways and Means Committee is soliciting feedback on the draft proposal from stakeholders. Although there is no official deadline for comments, the time frame for tax reform to begin moving is uncertain, so those interested in the proposal should act quickly to ensure that their voices are heard.
- **Momentum continues to build.** The draft proposal represents the latest stage in an ongoing effort by the congressional tax writing committees to pursue comprehensive tax reform. The Discussion Draft appears to be a House Republican proposal, rather than a bipartisan or bicameral product. However, Ways and Means Ranking Member Sander Levin (D-MI) appears to support the Discussion Draft as part of a strategy of raising revenues and closing loopholes to reduce the federal deficit.

If enacted into law, the proposals in the Discussion Draft would be effective for transactions entered into after December 31, 2013.

A few of the proposals, such as the hedging identification proposal, would benefit taxpayers. However, many of the proposals represent significant shifts from current policy that could adversely affect financial institutions, operating companies, and individuals. Those proposals would force reconsideration of current investment strategies. Below is a summary of the Discussion Draft's proposals and impact.

1. Provide Uniform Tax Treatment of Financial Derivatives

The taxation of derivatives has not kept pace with the increasing complexity of new financial instruments, such as swaps, and results in inconsistencies in the timing for recognition of gain or loss and the character of that gain or loss. For example, the Discussion Draft notes that the Code requires recognition of gain upon disposition or settlement of some financial derivatives, such as options and forwards, while other financial derivatives, known as Section 1256 contracts (including regulated futures contracts and foreign currency contracts), require that the taxpayer mark to market any gain or loss as of the last day of the taxable year. Any gain or loss on a Section 1256 contract is recognized 60 percent as long-term capital gain or loss and 40 percent as short-term capital gain or loss.

The Discussion Draft dramatically changes the taxation of financial derivatives for most taxpayers and repeals several existing applicable code sections, such as Section 1256. In general, the proposal calls for any gain or loss from all types of derivatives to be reported on an annual basis under a mark-to-market rule, and all gain or loss due to mark-to-market reporting would be treated as ordinary income. The Discussion Draft also expands the definition of derivative to include options, forwards, futures, and swaps. Moreover, the proposal would apply equally to privately held and publicly traded derivatives. Derivatives relating to real estate or entered into as part of a hedging transaction would be exempt from these special rules.

This proposal would significantly impact the attractiveness of investments in derivatives. Requiring recognition of gain or loss on options each year is a dramatic shift from current rules that tie recognition of gain or loss to the exercise or maturity of an option. Character mismatches will occur in several situations, such as when a share of stock underlying an option is sold for a capital gain or loss. Further, mark-to-market treatment is not currently required for many financial instruments, such as credit default swaps or interest rate swaps, meaning that financial institutions and investors using these instruments would need to assess the impact of recognizing gain or loss as ordinary income on a yearly basis on their return on investment.

There are also valuation and cash flow challenges associated with the mark-to-market rule. Many derivatives are multiyear obligations that fluctuate in value and do not provide an economic benefit to its holder before it is exercised. In certain situations, a taxpayer could be forced to recognize gain in one year when a derivative instrument ultimately resulted in loss upon expiration in the subsequent year. Additionally, illiquid and unique derivatives may be difficult to value on a year-to-year basis.

It is also important to note that the new higher ordinary income tax rate of 39.6 percent enacted in the American Taxpayer Relief Act would apply to yearly recognition of mark-to-market gain under the proposal. For certain taxpayers, the new 3.8% tax on unearned investment income that took effect on January 1, 2013 would also apply. If ordinary income and capital gains rates are reopened as part of a comprehensive tax reform debate, the derivatives proposal would need to be considered in light of any changes that are made to the rates.

2. Simplify Business Hedging Tax Rules

In a related proposal, the Discussion Draft proposes a new and easier method of allowing taxpayers to report their hedging transactions. Under Section 1221, taxpayers are required to identify the item or aggregate risk being hedged on the same day that a taxpayer acquires, originates, or enters into a hedging transaction. Relevant accounting rules under U.S. Generally Accepted Accounting Principles ("GAAP") require similar disclosure of hedging transactions, but such disclosure does not satisfy Section 1221 requirements unless the disclosure is identified as a hedging transaction for tax purposes.

The Discussion Draft's proposal addresses "foot faults" and inadvertent failures to properly and timely identify hedging transactions under Section 1221. The proposal would allow a taxpayer to meet the requirements of Section 1221 either by meeting the identification requirements of existing law or identifying the hedging transaction per GAAP in the taxpayer's audited and certified financial statements.

Importantly, the proposal does not affect the definition of a hedging transaction under the Code. Similarly, the proposal does not impact the relevant accounting standards under GAAP.

3. Eliminate "Phantom" Tax Resulting from Debt Restructurings – Cancellation of Debt Income

Generally, the Code provides that cancellation of indebtedness is includible in gross income. When debt is restructured, cancellation of debt ("COD") income may be triggered as a result of an exchange of one debt obligation for a new debt obligation or as a result of a modification of an existing debt obligation. These rules generally provide that a holder of debt must recognize gain or loss to the extent that the "issue price" of a new obligation (e.g., its fair market value) differs from the original debt.

Prior to 1990, debt restructurings that did not involve the forgiveness of principal were protected from potential COD income. The rule provided that the issue price of a new debt instrument could not be less than the adjusted issue price of the old debt instrument, which meant that there would be no COD income after restructuring debt (absent forgiveness of principal). This rule was repealed as part of the Omnibus Budget Reconciliation Act of 1990.

The Discussion Draft proposes reinstating the special COD rule for debt restructurings as a result of a "specified debt modification." A specified debt modification includes (1) an exchange by the debt holder of a new debt instrument for the existing debt instrument and (2) the amendment of an existing debt instrument, including a "significant modification" such as a change in timing for payments that results in a material deferral of scheduled payments. The new COD rule will provide particular relief for borrowers who seek to restructure their debt obligations, including mortgages, as a result of changing economic circumstances.

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

A taxpayer who purchases a bond at a discount (i.e., less than the amount to be repaid) generally must include the value of the discount as ordinary interest income. The inclusion of the discount as interest income can differ depending on whether a bond was acquired directly from an issuer or on a secondary market. If a bond is purchased directly from a purchaser, the purchaser is required to include the discount in taxable income as additional interest over the life of the bond. However, if a bond is purchased on a secondary market, a purchaser has the option of including the discount in taxable income as additional interest when the bond is retired or the purchaser resells the bond. Thus, the timing of taxable interest varies significantly depending on whether a bond is purchased directly from an issuer or on the secondary market.

The Ways and Means proposal would align the treatment of taxable interest income of bonds purchased directly from an issuer and bonds purchased on a secondary market. Purchasers of bonds on a secondary market would be required to report as interest income the sum of the daily portion of market discount for each day that the purchaser holds the bond, rather than having the choice of including that taxable interest in income when the bond was retired or sold. However, the amount of taxable interest would be limited to the greater of (1) the bond's original yield plus five percentage points or (2) the applicable federal rate for the bond at the time the bond was acquired, plus ten percentage points. These limits reflect the intent to limit taxable interest income only to the extent that interest rates have increased since a bond was originally issued.

Additionally, the Ways and Means proposal would revise the treatment of bonds acquired at a premium (i.e., for more than the amount to be repaid). Currently, a holder of a bond is entitled to a deduction of the premium on an amortized basis, but only after calculation of a taxpayer's adjusted gross income. The Ways and Means proposal allows a deduction for a bond premium "above the line," which would reduce adjusted gross income.

5. Rules Regarding Certain Government Debt

As discussed above, if the value of a bond declines after it is originally issued, the purchaser acquires it with a market discount. The Code treats the discount on certain short-term government obligations disparately, depending on the taxpayer. Specifically, a cash-basis taxpayer holding a non-interest bearing obligation may elect to include in income the increase in the value of the obligation when the obligation is paid at maturity or otherwise. In contrast, taxpayers using the accrual method of accounting must include the discount in current income.

The Discussion Draft harmonizes the tax treatment of such discounts, repealing the rule that taxpayers using the accrual method must report the discount in current income. As a result, all taxpayers have the flexibility to elect the most advantageous tax treatment.

Additionally, the Code generally requires that any increase in the value of a U.S. savings bond is includible in gross income in the taxable year that the bond is redeemed or at final maturity, whichever is earlier. The Code also allows taxpayers to exchange certain obligations without recognition of gain or loss, including individuals exchanging Series E or EE savings bonds for Series H or HH savings bonds. The Discussion Draft repeals the provision allowing for tax-free exchange of such bonds, as the Treasury no longer issues Series H or HH savings bonds.

6. Require Basis Reporting in Sales of Securities

Generally, the Code provides that if a taxpayer has purchased substantially identical securities at different times and different prices, shares subsequently sold or transferred are deemed to be the earliest acquired securities (first-in-first-out rule or "FIFO") and have the basis of such securities. However, a taxpayer has the ability to make a "specific identification," allowing the taxpayer to identify specific securities and use the basis of those particular securities. In so doing, a taxpayer who has purchased substantially identical securities at different times and prices can control the taxable gain or loss by choosing the basis of shares later sold. The rules were modified in 2008 for taxpayers who hold shares in a Regulated Investment Company ("RIC"). The RIC rules permit a taxpayer to elect, in lieu of FIFO or specific identification, an average basis method on an account-by-account basis, calculated to reflect the taxpayer's average basis in the securities held in an account, including any securities sold and retained during the year.

The Discussion Draft significantly expands the 2008 rule by requiring that the cost of any specified security disposed of on or after January 1, 2014 be determined in accordance with the average basis method. Unlike the RIC rules, which are permissive and allow the taxpayer to elect the average basis method, the Discussion Draft mandates the use of the average basis method for the sale of all securities. The proposal contains transition relief, treating any specified security acquired before the effective date as in a separate account and allowing the taxpayer to determine the basis of such securities using a previously acceptable method.

Additionally, a broker is currently required to report a customer's adjusted basis in a covered security that the customer has sold. The Discussion Draft requires that brokers use the average basis method in satisfying their basis reporting requirements.

Although the proposal reduces complexity for taxpayers in determining the gain or loss associated with the disposition of securities, the provision significantly reduces the ability of taxpayers to control such gain or loss by strictly prescribing how the basis must be calculated.

7. Limit Harvesting of Tax Losses on Securities

The Code contains so-called "wash sale" rules, preventing a taxpayer from immediately deducting losses from the disposition of securities if substantially similar securities are acquired by the taxpayer during the period 30 days before to 30 days after the sale. Under the rules, any such loss is deferred until the replacement securities are later sold.

Taxpayers have attempted to work around the wash sale rules by using a closely related party to acquire the replacement securities. Consequently, the IRS has issued guidance that if a taxpayer sells securities, and the taxpayer's spouse or controlled corporation buys substantially identical securities, the transaction constitutes a wash sale.

The Discussion Draft expands the wash sale rule, codifying the IRS guidance. For purposes of the proposal, a related party is defined broadly, including the taxpayer's spouse, dependents, individuals of whom the taxpayer is a dependent, and certain related individual, corporate, partnership, trust, estate, and investment or savings arrangements of or controlled by such individuals. Moreover, the Discussion Draft provides Treasury with the regulatory authority to prevent the avoidance of the wash sale rules, including adding additional related parties.

Next Steps

The Ways and Means Committee has requested comments and feedback regarding the Discussion Draft. As with the release of the international tax reform proposal in October 2011, we can expect that hearings will be scheduled to examine the costs and benefits of the proposal, and to assess the scope and impact on investors, financial institutions and the U.S. capital markets.

Moving forward, the path and timing for tax reform is uncertain. Congressional leaders on both sides of the aisle, along with President Obama, have called for an overhaul of the Code in recent weeks. The upcoming fiscal challenges facing Congress, including the debt ceiling, sequestration, and the federal budget, provide possible vehicles to pass a framework for tax reform. Such a framework could set revenue goals, targeted tax rates, and establish an expedited process for considering tax reform legislation later this year. However, tax reform discussions could occur even if a framework and a process are not included in upcoming legislation, although dealing with tax reform through regular order could take longer. Regardless of this uncertainty, the Ways and Means Discussion Draft shows that the tax reform debate is moving past discussions of high-level principles and towards specific policy proposals.

Given the accelerating pace of tax reform in the 113th Congress, we encourage you to weigh in on the merits and costs of the Discussion Draft. Concerned individuals, corporations, and financial institutions should take note that this is an early opportunity to engage with Congress on the shape of comprehensive tax reform.

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