Report No. 1318

New York State Bar Association Tax Section

Report on the House Ways and Means Committee Discussion Draft Provisions to Reform the Taxation of Financial Instruments and Corresponding Proposals by the Obama Administration

March 6, 2015

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This report[1] provides observations and recommendations concerning the provisions contained in the discussion draft of potential legislation released by the House Ways & Means Committee on February 21, 2014 (the "Discussion Draft") related to debt instruments, derivatives, tax basis and wash sales.[2] The report also refers in places to proposals made in President Obama's fiscal year 2016 budget proposal.[3]

We commend the Committee and its former Chairman, Representative David Camp, for this sweeping effort to rethink fundamental issues, and for advancing its proposals in the form of a discussion draft open to comment by taxpayers and other interested parties. Our observations and recommendations are meant to highlight issues that we believe will need to be

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[1] The principal authors of this report are William L. McRae and Erika W. Nijenhuis. Significant contributions were made by S. Douglas Borisky, Michael Farber, Stuart Goldring, Edward Gonzalez, Stephen Land, David S. Miller, David Schizer, David Schnabel, Michael Schler and Derek Wallace. Helpful comments were provided by Kimberly Blanchard, James R. Brown, David Hariton, Stephen Shay and David Sicular. The authors thank Elena Heim and Andrew Meiser for their assistance. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the New York State Bar Association Executive Committee or the House of Delegates.

[2] The text of the Discussion Draft and a Section-by-Section Summary can be found in the Ways and Means Committee Print, *Tax Reform Act of 2014*, 113th Cong. 2d Sess., as released on February 26, 2014 (WCMP 113-6, Sept. 2014), available at http://www.gpo.gov/fdsys/pkg/CPRT-113WPRT89455/pdf/CPRT-113WPRT89455.pdf (last visited January 19, 2015). Further official commentary can be found at Joint Committee on Taxation, *Technical Explanation, Estimated Revenue Effects, Distributional Analysis, and Macroeconomic Analysis of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code* (JCS-1-14, Sept. 2014), available at https://www.jct.gov/publications.html?func=showdown&id=4674 (last visited January 19, 2015).

A prior version of the Discussion Draft and a Technical Explanation of the Tax Reform Act of 2014 (Jan. 24, 2013) (the "Discussion Draft Technical Explanation"), can be found at http://waysandmeans.house.gov/uploadedfiles/leg_text_fin.pdf and at http://waysandmeans.house.gov/uploadedfiles/final_financial_products_discussion_dated_tomorrow.pdf, respectively (last visited January 19, 2015).

[3] These proposals are set forth in the General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals, published by the Treasury Department in February 2015, available at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf (last visited February 2, 2015). Similar proposals were made in the Administration's proposals for fiscal years 2015 and 2014. See General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals, published by the Treasury Department in March 2014, available at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf (last visited January 19, 2015); General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals, published by the Treasury Department in April 2013, and available at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf (last visited June 7, 2014). The Administration's proposals for fiscal year 2015 are further described by the Joint Committee on Taxation in *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposals* (JCS-2-14, Dec. 2014), available at https://www.jct.gov/publications.html?func=startdown&id=4682 (last visited January 19, 2015).

addressed, whether by legislation or through administrative guidance, in order for the proposed rules to be workable, and to identify questions and concerns with the proposals for policymakers to consider. After summarizing our comments and recommendations, the report is organized in four parts, discussing in turn the debt proposals, the derivatives proposals, the basis proposal and the wash sale proposal.

I. Summary of Comments and Recommendations.

A. Debt Proposals

There are two principal debt proposals in the Discussion Draft. Proposed section 1274B would modify the treatment of debt instruments issued in debt-for-debt exchanges to provide that where the principal amount of the debt is not reduced, the issue price of the newly issued debt instrument and the amount realized on the disposition of the old debt instrument generally will not be less than the adjusted issue price of the old debt instrument. A related provision, Proposed section 1037, generally would provide that a holder of the old debt instrument would not recognize gain or loss as a result of the exchange. Proposed section 1278 would require secondary market purchasers of debt instruments to accrue market discount, subject to a cap, replacing the elective accrual of current law. The Administration's proposals contain a similar market discount rule.

1. We generally support proposed section 1274B, which sets a floor on the issue price of debt instruments issued in debt-for-debt exchanges or deemed issued pursuant to significant debt modifications within the meaning of Treasury regulation section 1.1001-3. We believe that the rule will provide much needed relief to financially distressed issuers that would otherwise be required to recognize non-economic "cancellation of debt" ("COD") income from such exchanges.

2. It may be valuable for issuers to establish a single issue price for debt that is newly issued in a debt consolidation ─ that is, where identical debt instruments are issued in redemption of two or more classes of other debt of the same issuer. In those cases, a single issue price for the newly issued debt instruments will allow them to trade as a single, fungible issue and thereby provide liquidity. However, proposed section 1274B is likely to defeat that goal in many cases by requiring that the newly issued debt instruments have several different issue prices determined by reference to the issue prices of the different redeemed instruments. For that reason, we recommend that section 1274B be elective in the case of debt consolidations.

3. We do not believe that the general rules of proposed section 1274B should apply to protect issuers from COD income in the case of a related-party debt purchase that is treated as a redemption under section 108(e)(4). Although there are valid policy reasons for treating related-party purchases consistently with actual debt redemptions by a single issuer, we are concerned that applying proposed section 1274B to related-party purchases could allow taxpayers to shift COD income among related parties in ways that could present an opportunity for abuse.

4. We also support proposed section 1037, which provides non-recognition treatment of holders of debt obligations in debt-for-debt exchanges with the issuer.

5. We support the proposal to require current accrual of market discount, but recommend further consideration of whether holders of highly speculative debt should be required to accrue market discount (or any other income) prior to the receipt thereof.

6. We support the proposal to provide debt holders with ordinary character for losses realized on the sale of a debt instrument to the extent of previously accrued market discount and recommend that consideration be given to adopting a rule to address the character mismatch that arises when a holder is required to accrue "original issue discount" ("OID") on a current basis, and then sells the relevant debt instrument for a capital loss.

7. We believe that consideration should be given to adopting rules that allow holders of debt trusts and other pools of debt instruments to apply the market discount rules on an aggregate basis.

B. Derivatives Proposals

The derivatives proposals of the Discussion Draft provide that any "derivative" held by a taxpayer at the close of the taxable year is treated as sold for its fair market value (a "mark to market" regime), and that all items of income, gain, loss and deduction with respect to the derivative are treated as ordinary income or expense. The term "derivative" is broadly defined as any contract the value of which, or any payment or other transfer with respect to which, is determined by reference to one of more of the following: corporate stock; a partnership or trust interest; any evidence of indebtedness; real property (subject to certain exceptions); any actively traded commodity; any currency; any rate, price, amount, index, formula or algorithm; or any other item prescribed by the Treasury Department. Derivatives embedded into contracts other than debt instruments are required to be marked to market on a stand-alone basis, where stand-alone valuations of the derivatives are possible. In cases where the derivatives components of a larger contract cannot be valued on a stand-alone basis, the entire contract is to be treated as a derivative and marked to market.

Shares of stock, bonds or other debt instruments, commodities or other "physical" assets are also subject to this mark-to-market regime if they are part of a "straddle," which generally refers to a transaction consisting of a derivative and an offsetting position. In the case of a straddle, all positions in the straddle are subject to the mark-to-market regime. Any built-in gain (but not loss) on a physical asset is taken into account as taxable at the time the asset becomes part of a straddle.

The Administration proposal is similar, except that it applies only to derivatives on actively traded property, and the straddle mark-to-market regime applies only to actively traded stock that is hedged. The proposal provides authority for the Secretary to issue regulations to match the timing, source and character of a capital asset and a hedge thereof. The

Administration proposal would also bifurcate out a derivative contract embedded in any other financial instrument if the derivative by itself would be marked to market.

Comments and recommendations

In general

1. Marking derivatives to market has the potential to improve significantly the taxation of derivatives as compared to current law, by taxing taxpayers on their real economic income; reducing complexity; taxing similar economic positions consistently; increasing symmetry between different parties to the same transaction; promoting book-tax conformity; reducing arbitrage opportunities; making more efficient use of limited tax administration resources; and limiting the effect on "real" transactions and most taxpayers. However, a mark-to-market regime for derivatives also has potentially significant disadvantages, including valuation issues; liquidity issues resulting from the need to pay tax in the absence of cash; widening the disconnect between the taxation of derivatives and underlying assets; creating new arbitrage or whipsaw possibilities; raising complex issues relating to the hedging of capital assets; requiring new line-drawing exercises; and giving rise to a cliff effect between transactions treated as derivatives and those that are not.

   Whether a mark-to-market regime is preferable to current law in light of the marked advantages and disadvantages of such a regime described above is a very difficult determination and we do not believe that there is a clearly "right" choice. While marking derivatives to market solves many problems under current law, it creates many new technical issues. Moreover, any coherent and fair mark-to-market regime for derivatives would be, in our view, very complex and one must take this complexity in account in assessing the benefits of such a regime. On balance, we believe that a mark-to-market regime for derivatives could be a substantial improvement over current law, provided that (a) the regime is limited to actively traded derivatives and derivatives on actively traded underlying property or positions, and (b) workable rules are provided for "mixed straddle" transactions in which a non-derivative is hedged by or hedges one or more derivatives.

2. Regardless of whether a broad mark-to-market regime for derivatives is adopted, we recommend that investors in actively traded securities and commodities and related derivatives be permitted to elect to mark their positions to market, as is the case today for dealers and traders in securities and commodities. We suggest a number of limitations on this election that are intended to limit cherry-picking and potentially abusive transactions.

3. We recommend that the scope of the mark-to-market regime be limited to derivatives that are linked to actively traded property. Doing so eliminates many types of transactions that are not traditionally considered derivatives, such as a merger & acquisition contract to buy a controlling stake in a corporation, and

prevents a large set of potentially intractable valuation issues. We suggest a number of rules intended to limit controversy as to whether a particular type of derivative or property is within the scope of the rule. We also believe that limiting the mark-to-market regime to derivatives linked to actively traded property is founded on sound tax policy considerations, including reducing complexity, uncertainty and administrative issues as well as promoting fairness and easing liquidity concerns. We do not believe that the lack of any fundamental theoretical difference between a derivative on an actively traded asset and a derivative on an illiquid asset should be the sole consideration in determining the scope of a mark-to-market regime for derivatives. Good tax policy has always balanced a number of different considerations.

4. We recommend that taxpayers be required to value derivatives in the same manner that they value them for U.S. financial accounting purposes, where relevant, and that other taxpayers be permitted to rely on valuations provided by another party to a transaction that marks the derivative to market for non-tax reasons. Because there often may not be a single "true" value for a derivative, valuations should be respected if they are reasonable and the relevant taxpayer uses a consistent valuation methodology.

5. We support the exclusion from the scope of these rules for derivatives with respect to stock of members of a worldwide affiliated group.[4] To the extent not addressed by recommendation #3, a derivatives mark-to-market regime should be tailored so that it does not apply to merger & acquisition transactions, non-business or non-investment contracts entered into by individuals, and real estate transactions.

6. We recommend that the exclusion of compensatory options from the definition of a derivative be expanded to include other forms of equity-linked compensation.

7. We recommend that the exclusion, to the extent provided in regulations, of securities lending, sale-repurchase and similar financing transactions from the definition of a derivative be clarified to exclude such transactions from the definition of a derivative unless and until otherwise provided by regulations. Alternatively, the intended treatment of such transactions before regulations are promulgated should be clarified.

8. We support the repeal of the "60/40" holding period rules of section 1256. Whether mark-to-market gain or loss from derivatives should be capital or ordinary raises additional issues. For example, treating mark-to-market loss as ordinary means that taxpayers would be able to use losses from derivatives to offset income from their ordinary business operations. In view of the fact that taxpayers would no longer be able to choose the timing of losses, and that any gains would be taxed at ordinary income rates, we agree that ordinary income/loss

[4] The Discussion Draft contains a number of provisions dealing with insurance. This report does not discuss those provisions.

is the better answer. However, derivatives that otherwise would be capital assets for purposes other than determining the character of gain or loss should continue to be treated as such for those other purposes, in order to avoid inadvertent changes to other areas of the tax law.

Hedging capital assets

9. The Discussion Draft's "mixed straddle" (a straddle that includes both a derivative and non-derivative position) proposal has the potential advantages described above for mark-to-market regimes generally, including taxing true economic income and eliminating timing and character mismatches.

10. The proposal also raises difficult technical and policy issues, including the loss of long-term capital gain potential for straddles where gain is not hedged; the possibility of transforming built-in capital losses arising from anticipated changes in the market into recognized ordinary losses without the need to dispose of an asset; and the need for greater precision than exists today in determining what positions are part of a straddle. The Discussion Draft's proposal to accelerate the taxation of any built-in gain (but not loss) on positions held prior to becoming part of a straddle may allow taxpayers to refresh capital losses, and may appear punitive to other taxpayers. There are also many timing and character issues associated with holding a position post-straddle that are not addressed by the Discussion Draft.

11. We considered the feasibility of an alternative mixed straddle rule, namely a capital asset hedging transaction rule modeled on the hedging transaction rules of section 1221 and 446. This alternative also would be complex to implement.

12. Accordingly, we do not recommend any particular approach to dealing with mixed straddles. We are prepared to consider further how to address the issues we discuss for either proposal, or any other proposal. We believe that crafting a workable mixed straddle rule is essential to the viability of any mark-to-market regime for derivatives.

13. We support the treatment of bonds held by insurance companies as ordinary property for purposes of applying the hedging transaction rules of section 1221(b), and we recommend that consideration be given to treating debt hedges of other taxpayers as generally eligible for the same treatment.

14. If the Discussion Draft's mark-to-market rule for mixed straddles is adopted, we support the exclusion of straight debt from the built-in gain acceleration rule. We recommend, though, that Treasury have authority to expand the built-in gain acceleration rule to straddles involving straight debt in cases of abuse. We also support the exclusion of exchange-traded covered call options from the built-in gain acceleration rule, particularly in situations where gain is not locked in, but we recommend that the exclusion be extended to "over the counter" traded covered call options, consistent with current treatment under section 1092.

15. More generally, we recommend that built-in gain on straddle positions be marked to market only to the extent it would be today under section 1259.

16. The Discussion Draft should address the application of the rules to positions held by related parties. We recommend that positions held by a spouse or civil union partner or by a member of the same consolidated return group be treated as held by the taxpayer, and that Treasury have authority to treat positions held by other related parties as held by the taxpayer, or vice versa, where they are part of a transaction or series of transactions intended to avoid the mixed straddle rules.

Embedded derivatives

17. We did not reach agreement on how derivatives embedded in contracts, including debt instruments, or debt-like instruments such as structured notes, should be taxed. We recommend that derivatives embedded in other instruments, like stock, not be bifurcated.

18. Most of our members believe that derivatives embedded in debt and debt-like instruments should not be bifurcated and taxed on a stand-alone basis, because of the difficulty of isolating and valuing embedded derivatives, at least in cases where adequate rules already exist – the contingent payment debt instrument ("CPDI") rules, the variable rate debt instrument ("VRDI") rules, and other OID rules dealing with contingencies – to address them. If it is thought necessary to change how convertible bonds are taxed, we support the Discussion Draft's treatment of them as CPDIs (discussed below). A minority disagrees with this position and believes that bifurcating derivatives embedded in debt instruments is appropriate and feasible. Whatever approach is adopted, bond/warrant units and other similar units comprised of one or more debt instruments and derivatives should be subject to the same rules if the components of the unit are not expected to be separated during their life.

19. If embedded derivatives in debt and debt-like instruments are not bifurcated, possible alternatives include requiring the entire instrument to be marked to market, or requiring the accrual of income on the instrument. In this regard, the Discussion Draft provides that if an embedded derivative that would otherwise be bifurcated cannot be separately valued, the entire contract is treated as a derivative and marked to market. This treatment could be extended to embedded derivatives that would not otherwise be bifurcated. A mark to market approach is closer to the treatment of derivatives on a stand-alone basis, but an accrual approach could be easier for holders to manage because it does not require valuation. An accrual approach also eliminates any concerns about issuers marking their own debt to market.

20. We also considered the possibility of selecting one of the rules described above as a default rule, but permitting taxpayers to elect a different rule. Another possibility is to provide, or permit, different rules for holders and issuers in view of the different considerations applicable to them.

21. Regardless of what general rule is adopted for debt and debt-like instruments with embedded derivatives, if such an instrument is hedged by a derivative, and the embedded derivative component is closely related to the stand-alone derivative, we support bifurcating and marking the embedded derivative.

Convertible Bonds

22. If it is thought necessary to change how convertible bonds are taxed, we support the Discussion Draft's treatment of them as CPDIs. We believe this rule generally will produce a result comparable to the case of an investment unit consisting of straight debt and a warrant ─ once the Discussion Draft's proposal to treat premium on a warrant as income to the issuer is taken into account. In either case (convertible bond as CPDI and bond/warrant unit), the issuer will accrue interest and OID deductions over the term of the debt, with offsetting income if the convertible bond is not converted or the warrant is not exercised.

23. If the Discussion Draft's treatment of convertible bonds as CPDIs is adopted, we recommend clarifying that, under section 249, the issuer's interest deduction is capped at the bond's comparable yield, even if the value of the stock delivered on conversion exceeds the adjusted issue price under the CPDI rules.

24. We recommend assuring that the treatment of convertible bonds as CPDIs is coordinated with section 305. If new regulations are to be promulgated specifically to address convertible debt, it may be desirable to address income from the adjustment of conversion ratios in the context of those regulations.

Derivatives on an Issuer's Stock

25. We support the Discussion Draft's extension of nonrecognition treatment under section 1032 to income and gain from derivatives on the issuer's stock.

26. We further support the Discussion Draft's exclusion of derivatives on the stock of other members of a worldwide affiliated group from the definition of derivative (and thus from the new market to market rule).

27. We support the Discussion Draft's proposal to tax a corporation on income derived from acquiring its stock and, pursuant to a plan, selling it under a forward contract, subject to comments we have previously submitted.[5]

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[5] *See* New York State Bar Association Tax Section Report No. 954, *Report on Section 1032* (June 16, 1999) (recommending that Clinton Administration proposal to tax a corporation on income from forward sales of stock be limited to transactions in which the corporation acquires its stock and substantially contemporaneously enters into a contract to sell its stock forward at a fixed price), available at http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_1999/Tax_Section_Report_954.html (last visited January 19, 2015); New York State Bar Association Tax Section Report No. 964, Letter to The Honorable William V. Roth, Jr. on H.R. 3283 (March 17, 2000) (commenting on a bill submitted by Representative Neal addressing a corporation's purchase of stock and forward sale of that stock).

28. The Discussion Draft's treatment of warrant premium is beyond the scope of the report.

C. Basis of Securities Proposal

Section 3421 of the Discussion Draft provides that the basis of securities generally will be determined under a "first-in first-out" ("FIFO") method. By contrast, under current law, FIFO is the default rule but the taxpayer has the option of specific identification. The mandatory FIFO method would apply separately to securities in different accounts. The Administration proposal by contrast would require an average basis methodology, would apply only to portfolio stock held for a long-term holding period, and would apply to all identical securities held in all of a taxpayer's taxable accounts.

Comments and recommendations

1. In principle, we support the adoption of a single method for determining the basis of portfolio stock, because current law's electivity does not have a policy basis. In practice, however, we question whether the alternatives that are available represent a significant enough improvement over current law to warrant changing it.

2. An average basis method for determining the basis of portfolio stock more clearly reflects taxpayers' economic gain or loss on the disposition of securities than any other method. It would, however, be extremely complex to implement in practice without centralized basis reporting.

3. If an average basis method is adopted, we would recommend that the basis be determined by taking into account all securities of the same kind held by the taxpayer in all of its accounts. As proposed by the Administration, the average basis rule should be limited to securities with a long-term holding period. We would recommend that Treasury be given authority to provide rules for a number of complex situations where current law provides complex basis rules, and that the average basis rules be coordinated with the net investment income rules of section 1411.

4. To make it feasible to apply a single average basis method across all of a taxpayer's accounts, ideally all brokers holding securities for that taxpayer should report information to a single aggregator of that information. Unless information about the taxpayer's basis in securities held in all of its accounts can be pooled in this manner, the benefits of the new cost basis reporting rules under section 6045(g) will be lost. We doubt that the theoretical benefits of an average basis method would be realized in the absence of accurate cost basis reporting.

5. A mandatory FIFO method for determining the basis of portfolio stock has the advantages that it is a well-known method; is readily administrable if applied on an account-by-account basis; arguably is an appropriate realization method; and reduces somewhat the level of electivity in current law. In practice, however, an account-by-account method allows well-advised taxpayers to retain much of the

electivity of current law. Accordingly, in our view, mandatory FIFO on an account-by-account basis does not constitute a significant enough improvement over current law to mandate changing current law.

6. If mandatory FIFO is adopted, we recommend that all accounts at a single broker be treated as a single account.

7. If any single method is adopted, we recommend that additional consideration be given to the effect of applying a single basis method to closely-held stock, in particular for purposes of the subchapter C, subchapter S and international tax provisions of the Code, or to debt instruments.

D. <u>Wash Sale Proposal</u>

The wash sale proposal of the Discussion Draft provides that the wash sale rules apply to transactions in which a taxpayer sells securities at a loss and a related party acquires substantially identical securities. Generally, in that case, the loss would be disallowed, rather than being carried into the basis of the replacement property as under current law. There is no comparable provision in the Administration proposals.

Comments and recommendations

1. We support the expansion of the wash sale rules to transactions involving related parties.

2. We do not believe that the loss on the sale of the securities by the original party should be disallowed. We recommend that in related party transactions the loss on the original sale be suspended, and taken into account either when the property is disposed of by the related party or the party ceases to be related. The model for these rules would be the intercompany transaction rules that apply to sales between members of a consolidated group.

3. We recommend that Treasury be given authority to apply these rules to additional related party transactions under appropriate circumstances. We also recommend that an exception be made for losses realized by a dealer in the ordinary course of its dealer business. This exception would be modeled on dealer exceptions under section 108 and subpart F under current law.

II. **Debt Proposals.**

A. <u>Rule On Debt-for-Debt Exchanges and Significant Modifications of Debt</u>

1. *Proposed Section 1274B's Treatment of Issuers* .

As an initial matter, we support proposed section 1274B contained in the Discussion Draft, which would change the rules regarding how modifications of publicly traded debt are taxed. Under the current rules, an issuer of debt that is "publicly traded" within the meaning of Treasury regulation section 1.1273-2 could be forced to recognize COD income in cases where the issuer in fact has not been relieved of any legal debt obligation. Similarly, issuers have been able to use the same rules to deduct repurchase premium for their debt in cases where their debt trades at a premium to face, but where they in fact have made no actual premium payment to holders.

These non-economic results arise due to the interaction of two separate rules. First, Treasury regulation section 1.1001-3 provides that, when the terms of a debt instrument are modified in a manner giving rise to a "significant modification," the significant modification is treated as a redemption of the unmodified debt in exchange for the modified debt. Second, Treasury regulation sections 1.1273-2(b) and (c) provide that, if debt is either "publicly traded" or issued in exchange for publicly traded property, then the debt's issue price is deemed to be its *fair market value*, rather than its face amount.[6] Accordingly, when publicly traded debt undergoes a significant modification, the issuer is treated as retiring the unmodified debt for the fair market value of the modified debt deemed issued in exchange therefor.

For an example of how these rules can affect issuers adversely, consider publicly traded debt with a face amount of $1,000 that was originally issued at par but now is trading at $400 due to a concern that the issuer will not be able to meet its debt obligations when due. In such a case, it would not be unusual for the issuer to attempt to seek some form of debt relief from its creditors by modifying the terms of the debt obligations ─ extending the maturity date, providing for deferrals of interest payments or a change in the interest rate, relaxing certain financial covenants, etc. If the issuer were successful, and if any such modifications were considered to constitute "significant modifications" within the meaning of Treasury regulation section 1.1001-3, then the issuer would be treated as having retired a $1,000 obligation for a new obligation worth only $400, and would be required to recognize $600 of COD income, *even though the issuer continues to owe the full $1,000 face amount*.

The issue price of the modified debt instrument would be considered to be $400, and the difference between the $400 issue price and the $1,000 face amount would be treated as OID that the issuer might be able to deduct as interest expense over the term of the instrument. The issuer thus would be presented, at a minimum, with a timing mismatch that could present a significant cost in present-value terms. If the modified debt qualifies as an "applicable high yield debt obligation" ("AHYDO"), however, the issuer would be unable to deduct OID until paid (exacerbating the timing problem), or in certain cases, would be denied a portion of the OID deductions altogether.[7] In the latter case, the issuer is effectively subject to tax on phantom income as a cost of restructuring its debt.

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[6] As a technical matter, if the newly issued debt is itself publicly traded, then the issue price of the debt is determined under Treasury regulation section 1.1273-2(b)(1) and is the fair market value of the newly issued debt. If the newly issued debt is not publicly traded, however, but is issued in exchange for publicly traded property (including issued in redemption of other debt that is publicly traded), then the issue price is determined under Treasury regulation section 1.1273-2(c) and is the fair market value of the property in exchange for which the debt was issued. As a practical matter, in the case of most corporate debt-for-debt exchanges (whether deemed or actual), this is a distinction without a difference.

[7] The AHYDO rules apply to certain debt instruments with yields greater than five percent above the "applicable federal rate" ("AFR") applicable to the debt instrument, and disallow interest deduction in some cases where a debt instrument's yield exceeds the AFR by more than six percent. *See* section 163(e)(5).

Prior to 1990, this non-economic recognition of COD income largely would have been prevented by then-current section 1275(a)(4), which provided that, in a debt-for-debt exchange effected by means of a corporate reorganization within the meaning of section 368, the newly issued debt would never have an issue price lower than the adjusted issue price of the retired debt.[8] Thus, in our example of the deemed redemption/reissuance of the $1,000 debt obligation (and assuming the deemed exchange qualified as section 368 reorganization), the issue price of the modified debt would have been $1,000, regardless of the debt's trading value or of what its issue price would have been in the absence of prior section 1275(a)(4). In this way, section 1275(a)(4) provided a floor on the issue price of modified debt and operated as a kind of-anti-COD provision for corporate issuers in debt-for-debt exchanges. The rule provided no relief for debt-for-debt exchanges that did not qualify as corporate reorganizations, and provided no relief for debt issuers that were partnerships or other non-corporate entities.

Prior section 1275(a)(4) was repealed in 1990, however, largely because of one specific potential for abuse. Under its literal terms, prior section 1275(a)(4) took no account of whether the debt issued in a debt-for-debt exchange had the same principal amount as the retired debt. Arguably, therefore, it would have been possible under that prior section 1275(a)(4) for the issuer in our example to reduce the principal amount of its debt obligations and still rely on prior section 1275(a)(4) to set the issue price at $1,000. Of course, under that result, the issuer would have realized the benefits of an *actual cancellation* of a portion of its indebtedness without recognizing any currently taxable COD income. Congress therefore repealed prior section 1275(a)(4) at least in part to deny taxpayers the ability to lower the actual amount of their obligations without recognizing the corresponding COD income.

In adopting the current rule for debt-for-debt exchanges (including exchanges deemed to occur as the result of a significant modification), Congress presumably decided that it would be more straightforward ─ and provide fewer opportunities for abuse ─ to have a single, uniform set of rules for determining the issue price of all debt instruments, rather than attempt to provide some special rule applicable only to debt-for-debt exchanges. As explained above, however, the wholesale repeal of prior section 1275(a)(4) merely replaced a non-economic result that arguably under-taxed issuers with a non-economic result that now over-taxes issuers. In 1991, the Tax Section issued a report arguing for the reinstatement of prior section 1275(a)(4) with modifications designed to address the concerns discussed above.[9] In 1994, the American Bar Association published a report taking a similar position.[10]

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[8] Repealed section 1275(a)(4) applied to debt instruments issued in a section 368(a) reorganization in exchange for another debt instrument. The issue price of the newly issued debt instrument was to be determined under the general principles of sections 1273 and 1274, except that issue price could not be lower than the adjusted issue price of the redeemed debt instrument.

[9] Specifically, the Tax Section recommended that prior section 1275(a)(4) be reinstated with a clarification that the issue price of debt issued in a debt-for-debt exchange could not be greater than its stated principal amount. *See* "New York State Bar Association Tax Section Report of Ad Hoc Committee On Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-For-Debt Exchanges," issued by NYSBA on March 25, 1991, available at http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_1991/Tax_Section_Report_686.html (last visited February 23, 2015). Proposed section 1274B effectively implements that recommendation.

[10] *See* American Bar Association Section of Taxation, "The Case for Reinstatement and Expansion of Section 1275(a)(4)," Jan. 10, 1994 (the "1994 ABA Report").

In considering the impact of the current rules requiring inclusion of non-economic COD income, it is worth noting that the rules disproportionately impact issuers in financial distress. Such issuers are most likely to undergo debt modifications that could give rise to a deemed redemption/reissuance of debt, and during the recent financial crises, the concern regarding such issuers caused the government to adopt emergency measures to mitigate the effects of non-economic COD inclusions. Section 108(i), for example, allowed issuers to elect to include COD income ratably over a period of five years, as opposed to a full immediate inclusion at the time of the real or deemed realization event. Section 163(e)(5)(F) generally suspended the application of the AHYDO rules for fifteen months in the case of debt instruments issued (or deemed issued) in exchange for debt of the same issuer that was not previously subject to the AHYDO rules.[11]

Perhaps in an effort to create symmetry in the law following the repeal of section 1275(a)(4), regulations were finalized in 1994 that allow issuers to benefit from a current deduction in cases where their publicly traded debt instruments are trading at a *premium* to their adjusted issue price. Treasury regulation section 1.163-7(c) allows issuers to deduct currently any premium paid to redeem a debt instrument, and provides specifically that "in a debt-for-debt exchange, the repurchase price is the issue price of the newly issued debt instrument." The consequence of this rule is that, when publicly traded debt is trading at a premium to its adjusted issue price, issuers have the ability to modify the terms of the debt in a way that constitutes a "significant modification" and thus gives rise to a deemed redemption/reissuance of the debt. Because the issue price of the modified debt is at a premium to the adjusted issue price of the original debt in this example, the issuer is entitled to deduct that premium currently. The holders of the debt instruments could be expected to be largely indifferent to the transaction as a tax matter, because the deemed redemption/reissuance is likely to qualify as a non-taxable exchange under section 354. In the late 1990s, this strategy was widely utilized by U.S. corporations, because a decline in interest rates had the result that many previously issued fixed-rate corporate bonds were paying what were then considered to be above-market coupons, and thus trading at a premium.

In the absence of a change to current law, the impact of these rules is likely to expand in the future, because Treasury regulation section 1.1273-2(f), finalized in early 2013, greatly expanded the universe of debt instruments that will be considered to be "publicly traded." Prior to the finalization of the current regulations, for example, it was unusual for bank loans to be considered "publicly traded," and thus issuers generally were able to modify the terms of such loans without serious concerns about realizing COD income. Now, most syndicated bank loans to large corporations probably do qualify as publicly traded.

11 As the acronym implies, the AHYDO rules are targeted at "high yield" obligations. The current environment of very low interest rates, however, has expanded the application of the AHYDO rules to instruments with yields that are not considered to be particularly high by historical standards, and that may not have been considered to be "high yield" when they were issued.

For the reasons discussed above, we support the general policy underlying proposed section 1274B, which is to reinstate the prior rule of section 1275(a)(4) in a modified form.[12] Specifically, proposed section 1274B would provide that:

> "In the case of an exchange (including by significant modification) by an issuer of a new debt instrument for an existing debt instrument issued by the same issuer, the issue price of the new debt instrument shall be the least of – (1) the adjusted issue price of the existing debt instrument, (2) the stated principal amount of the new debt instrument, or (3) the imputed principal amount of the new debt instrument."

The reference to "imputed principal amount" in clause (3) is from section 1274, which tests the payment streams on a debt instrument to determine whether the instrument reasonably could be worth its face amount on a net-present-value basis. Section 1274 provides generally that, where a debt instrument is issued for non-publicly traded property, the debt's issue price will be its face amount, unless the stated interest rate is below a minimum acceptable level (the "applicable federal rate" or "AFR"). If the interest rate on the debt is below the AFR, then the debt is considered not to be worth its full face amount on a net-present-value basis, and the issue price of the debt accordingly is deemed to be a lower "imputed principal amount," which is the issue price required in order for the debt to have sufficient additional interest (in the form of OID) to meet the minimum statutory requirement.

By establishing the "floors" for the issue price of a debt instrument listed above, proposed section 1274B generally addresses the concerns of issuers under current law that they could be forced to recognize COD income in cases where they have not been relieved of a legal liability.[13] Furthermore, the rule also provides safeguards against the concerns raised under prior section 1275(a)(4), by requiring issuers to accept a lower issue price on the new debt instruments in cases where either (i) there has in fact been a reduction of the stated principal amount of the issuer's legal obligation, or (ii) the new debt has such a low stated interest rate that it is not deemed to provide an economic rate of return without the invocation of section 1274.[14] Also, by

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[12] Proposed section 1274B is consistent with recommendations recently made by the American Bar Association in its 2011 report entitled "Options for Tax Reform in Financial Transactions Tax Provisions of the Internal Revenue Code" (the "2011 ABA Report"), and appears to have been modeled on those recommendations.

[13] One exception to that general statement arises in the case where the existing debt instrument was issued at a premium to its face amount. Because the issue price of the new debt cannot ever be *greater* than its face amount under proposed section 1274B, an issuer may recognize COD to the degree of any premium on the original debt instrument that has not already been amortized by the issuer. We believe this result is appropriate where the original debt instrument was issued for cash, because the COD income would relate to a premium payment already received by the issuer, and thus would *not* represent phantom income. In addition, any detriment to the issuer is solely a timing detriment, since the premium amount recognized as COD income otherwise would have accrued into the issuer's income over time. Although one might argue that the recognition of non-economic COD income is similarly a timing issue (because COD income is offset later by corresponding OID deductions), we believe that the COD issue discussed above is more of a problem because (i) the issuer's ability to offset COD income with OID deductions may be limited by the AHYDO rules, and (ii) the COD rules are likely to affect financially distressed companies disproportionately, and thus are more likely to burden companies that are less able to bear the burden.

[14] For these purposes, proposed section 1274B(b) provides that the discount rate used for measuring the new debt under section 1274 will be the *lesser of* (i) the AFR in effect upon the issuance of the new debt, and (ii) the *greater of* (a) the stated interest rate on the existing debt instrument, and (b) the AFR in effect when the original debt instrument was issued. The effect of this rule is taxpayer favorable, in that, by choosing the lesser of the two

ensuring that the issue price of the new debt instrument is never greater than its stated principal amount, the rule denies issuers the ability to plan into a debt-for-debt exchange with the intention of deducting an issuance premium in respect of the new debt. In general, we believe that the approach of proposed section 1274B is a sound one, and the remainder of this Section II.A.1 discusses two points where we wish either to confirm our understanding of the intended operation of proposed section 1274B, or to suggest drafting changes that we believe reflect the drafters' intent.

First, we note that proposed section 1274B treats the modification of the principal amount of a debt instrument differently from the modification of interest payments. A reduction in the principal amount of a debt instrument can give rise to COD income under proposed section 1274B, while a reduction in the interest rate will not, assuming that the reduced interest rate satisfies the AFR requirement of section 1274, discussed above. From the non-tax point of view, this distinction does not comport well with economic reality. A standard method for valuing debt instruments, for example, requires finding the sum of the present values of *all cash payments* owed by the issuer (determined using a uniform discount rate), regardless of whether the payments are denominated as principal or interest. We believe that this distinction is appropriate in proposed section 1274B, however, because of the fact that interest payments generally are deductible, whereas the payment of principal is not. Under section 108(e)(2), an issuer is not required to recognize COD income to the extent it is relieved from an obligation to make a deductible payment. Furthermore, to the extent the principal amount of a debt instrument represents cash that has been paid to the issuer, the reduction in the issuer's obligation to return that cash constitutes a genuine economic benefit that we believe is appropriate to tax.

Second, we believe that it should be clarified whether the anti-avoidance rule of section 1274(b)(3) is to be taken into account when determining the issue price of debt under section 1274B. Section 1274(b)(3) states that, notwithstanding the general rules for determining "imputed principal amount" under section 1274, the issue price of a debt instrument will be determined by reference to the debt's fair market value in certain cases that are determined in Treasury regulations to present the potential for tax avoidance.[15] We recommend that this anti-avoidance rule be excluded from the application of proposed section 1274B because we believe that the rule serves a purpose that is different from the purpose of proposed section 1274B. Specifically, section 1274 operates generally as a default rule for determining the issue price of a debt instrument in cases where the debt instrument has not been issued for cash and where there is no public trading information to establish the debt's fair market value with accuracy. In that case, section 1274 presumes that the issue price of the debt instrument is equal to its face amount (assuming adequate stated interest). The presumption, however, operates as a rule of convenience and administrability by abandoning the attempt to find evidence of the debt instrument's fair market value in cases where the effort presumably is not worth the incremental benefit. Section 1274(b)(3) accordingly turns off this presumption in situations (such as a recent

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discount rates in clauses (i) and (ii), the rule picks the rate that will lead to the largest net-present-value for the new debt instrument and thus reduces the chance that an instrument's stated principal amount will be replaced by a lower "imputed principal amount" for tax purposes. The fact that one of those two rates is the greater of (a) and (b) in the sentence above merely has the effect of ensuring that whichever rate was considered the appropriate rate of return for the existing debt at the time of issuance (either the then-current AFR or, if greater, the stated coupon rate) is the rate that is then compared to the current AFR at the time of the exchange. This approach strikes us as sensible.

15 *See* Treasury regulation section 1.1274-3.

sale of the debt instrument, or the issuance of the debt instrument as part of a non-recourse financing) where the effort to determine fair market value is worthwhile ─ *i.e.,* where there is evidence to establish the debt's fair market value and where the presumption could lead to inappropriate tax avoidance.

Section 1274 thus appears to be premised on the notion that a debt instrument's fair market value generally is the "gold standard" for determining issue price, and that the standard should be abandoned only for reasons of administrability and only where there is no potential for inappropriate tax avoidance. Proposed section 1274B, by contrast, is a clear *rejection of the fair-market-value standard* in order to provide issuers relief from the recognition of non-economic COD income ─ even in the case where debt is publicly traded and has a readily determinable fair market value. For that reason, we believe that the anti-avoidance rule of section 1274(b)(3) operates to set the issue price of a debt instrument at its fair market value for reasons that are inconsistent with the policy underlying proposed section 1274B. Accordingly we believe that proposed section 1274B should not take account of section 1274(b)(3).

For the reasons discussed above, we support the inclusion of proposed section 1274B in the Discussion Draft, and the discussion above describes areas where we either wished to confirm certain technical aspects of the operation of proposed section 1274B or wished to suggest that certain points be clarified. Section II.A.2 and 3, immediately below, contain recommendations to modify certain aspects of proposed section 1274B. Section II.A.4 then discusses proposed section 1037, which provides that debt-for-debt exchanges involving the same issuer generally would be non-taxable events for debt holders.

2. *Consider Making Proposed Section 1274B Elective in Debt Consolidations.*

This section discusses ways to mitigate a potential negative impact that proposed section 1274B could have on debt consolidations. In a debt-for-debt exchange, as discussed above, proposed section 1274B determines the issue price of the newly issued debt by reference to the issue price of the debt that is redeemed. Therefore, if identical debt instruments are issued at the same time in redemption of two or more different debt obligations with different adjusted issue prices, then those newly issued identical instruments similarly will have different issue prices. If the consequence of that fact is that certain of the newly issued debt instruments will have OID, while others will not (or will have OID in different amounts), then the new instruments will not be fungible with one another for tax purposes. Because issuers often undertake debt consolidations of this sort for the purpose of replacing several small, illiquid issuances with a single, large liquid issuance, the fact that the new debt instruments may not be able to trade as a single fungible group could undermine severely the utility of the consolidation.

Although we are concerned with the fungibility issue arising in the case of consolidations, the issue is not a novel one, and the treatment of the issue under current law is instructive. A similar issue under current law arises out of the fact that not all debt-for-debt exchanges constitute realization events for U.S. federal income tax purposes. For example, if the terms of debt instruments issued in a consolidation do not "differ materially in kind or extent" (within the meaning of section 1001) from the terms of one or more of the smaller issuances being redeemed, then the issuance of the new debt in exchange for those smaller issuances will *not* constitute a realization event ─ *i.e.*, those exchanges generally will be ignored for U.S. federal income tax purposes.[16] In that case, the newly issued debt instruments will be viewed as a continuation of the debt that they replace and generally will have the same tax attributes (including issue price) as those of the replaced debt instruments ─ and thus the newly issued debt instruments will not necessarily share uniform attributes among themselves and will not be fungible with one another.

If the redemption of other small debt issuances in exchange for the newly issued debt *does* constitute a realization event, however, the debt securities issued in those exchanges would have their issue price determined in accordance with the rules under sections 1273 and 1274. Thus, there should be a uniform issue price ─ and tax fungibility ─ among all of those newly issued debt securities. Accordingly, issuers seeking to consolidate their debt securities under current law may prefer that the component debt-for-debt exchanges be treated as realization events for tax purposes, so that the issue price of all debt securities constituting a new issuance will be the same.

In order to address the fungibility issues under current law discussed above, Revenue Procedure 2001-21[17] allows issuers and holders participating in a debt consolidation to elect to treat a debt-for-debt exchange as giving rise to a realization event, even when the exchange otherwise would not constitute a realization event under general tax principles. Under the revenue procedure, if a debt-for-debt exchange is the subject of such an election, then the issue price of the newly issued debt is determined under the general rules in sections 1272-1274 and *not* by reference to the adjusted issue price of the debt that was redeemed.

The holders and issuers making an election under Revenue Procedure 2001-21 do not recognize gain or loss currently at the time of the exchange, but are required to take the gain or loss into account over the term of the newly issued instrument. For example, amounts that otherwise would constitute COD income to the issuer are amortized into income over time as bond premium (or as an offset to OID deductions).

In the event that proposed section 1274B is enacted into law, we believe it would be appropriate to consider whether issuers should be able to elect into an alternative treatment for debt-for-debt exchanges that would allow them to achieve uniformity of issue price for debt issued as part of a debt consolidation. For example, if an issuer were willing to recognize COD income (or amortize COD income over time, in a manner similar to that provided in Revenue Procedure 2001-21) in order for the issue price of its newly issued debt to be determined in accordance with current sections 1273 and 1274, then we believe that such an outcome would be appropriate. Similarly, if the issuer were contemplating an exchange of debt trading at a premium to its adjusted issue price, perhaps it would be appropriate to allow the issuer to

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[16] The exchanges are not completely ignored, in that the debt instrument is treated as redeemed and reissued for purposes of establishing the appropriate OID amortization schedules and the like. *See* Treasury regulation section 1.1275-2(j).

[17] 2001-1 C.B. 742.

determine the issue price of the new debt under current sections 1273 and 1274 without taking a current deduction for repurchase premium.[18]

Of course, it is not necessary to determine the issue price of new debt instruments under current sections 1273 and 1274 in order to ensure that the issue price of the instruments is uniform and that the instruments are fungible with one another. There are several forms that such an election might take: the issuer could elect for the issue price of its newly issued debt to be equal to its face amount, for example, or it would be possible to establish some "blended" issue price based on an average of the adjusted issue prices of all of the issuances redeemed in the debt-for-debt exchange. However, a rule under which the issue price of debt is determined by reference to the debt's face amount could produce non-economic results and create opportunities for abuse, such as many of those discussed above in this Section II.A. Similarly, a rule looking to a blended issue price presumably would require the issuer to determine the blended issue price of the modified debt and make the price widely known to all of its debt holders, and then would require each debt holder to determine its gain or loss realized in respect of the debt-for-debt exchange by reference to a price that is unlikely to correlate directly to any features of that holder's specific debt instrument. That approach strikes us as creating considerable administrative burden in order to achieve a non-economic outcome. On balance, therefore, we believe that an election back to the general principles of current sections 1273 and 1274 offers the most straightforward rule, and we see no advantages to alternative methods of determining a uniform issue price for the newly issued debt.

So long as the election by its terms prevents the issuer from taking a non-economic tax benefit in respect of debt repurchase premium created by a material modification, then the election should not present any material opportunity for abuse. Similarly, we recommend against requiring issuers to recognize upfront the full amount of non-economic COD income currently as the price of achieving fungibility. Perhaps some sort of amortization of COD income over a timeframe similar to that provided in Revenue Procedure 2001-21 could be appropriate, as the COD income could then be used to cancel out the OID deductions that a reduced issue price would bring. Similarly, the deduction otherwise allowable in respect of repurchase premium could be taken over time to offset premium amounts that are amortized into the issuer's income. In fact, an accounting system that matches upfront COD income/premium deduction to the offsetting deduction/income produced later at least arguably meets the "clear reflection of income" standard contained in section 446 better than the current regime does.

Finally, we note that, to the degree Revenue Procedure 2001-21 serves as a model for an election out of the general rule of proposed section 1274B, the revenue procedure is available only for U.S. dollar-denominated debt of issuers (including qualified business units) with the U.S. dollar as their functional currency. In our experience, this requirement has greatly limited the relevance of the revenue procedure outside of the limited context of government-backed issuers, such as Freddie Mac and Fannie Mae. In recent years, many of the most

[18] In order to coordinate proposed section 1274B with the election provided by Revenue Procedure 2001-21, we believe it would be appropriate to update the revenue procedure to provide, as a default rule, that any realization event deemed to occur would be treated as a debt-for-debt exchange giving rise to consequences generally provided for under proposed section 1274B. Then, once taxpayers are under the general rules of proposed section 1274B, they would be eligible, in appropriate circumstances, to make the further election to be treated under the general principles of sections 1273 and 1274, rather than under proposed section 1274B.

prominent debt consolidations have been undertaken by foreign sovereigns, such as Argentina and Greece, where both the issuers and the debt holders had strong interest in promoting liquidity in the restructured debt of the issuers. Although we recognize that this limitation under Revenue Procedure 2001-21 may prevent foreign issuers from electing, say, to provide their debt holders with taxable losses without any offsetting recognition of COD income, we note that an election to determine the issue price of debt in accordance with the principles of sections 1273 and 1274 merely replicates the result that would obtain under current law if the exchange were recognized as a clear realization event. In addition, if proposed section 1037 were enacted as currently contemplated in the Discussion Draft, debt-for-debt changes generally would be nontaxable, and the point would become moot. Under the current system, we are not aware of widespread examples of issuers seeking to consolidate their debt for tax-motivated purposes, and would urge that the election be available to non-U.S. issuers and U.S. issuers alike.

In addition, the election under the revenue procedure is available only in cases where neither the redeemed debt nor the newly issued debt is a CPDI, a tax-exempt obligation, or a convertible debt instrument. Although we cannot identify the precise concerns underlying all of these restrictions, presumably the restrictions are intended to ensure that taxpayers will not be able to "game the system" by electing into a realization event with asymmetrical consequences. Again, because the election we suggest would replicate the results generally available under current law when a realization event is deemed to occur (albeit without current recognition of COD income or premium deductions), and because we believe that the goal of achieving tax fungibility in debt consolidations is an important one, we would caution against putting conditions on the election that are not targeted at specific abuses or concerns already identified under current law. In this regard, we note that Treasury regulation section 1.1275-2(g) contains an anti-abuse rule that gives the Service broad authority to correct "unreasonable results" arising from tax-motivated transactions.

3. *Interaction of Section 1274B and Section 108(e)(4)* .

We have considered whether the rules of proposed section 1274B should apply to allow issuers to avoid COD income in cases where debt of an issuer is purchased by a related party (within the meaning sections 267(b) and 707(b)(1)), such that the purchase is treated as a redemption by the issuer under section 108(e)(4). On the one hand, to the degree that section 108(e)(4) is premised on the notion that related parties should be treated as if they were a single entity for purposes of the COD rules, it follows that a related-party purchase of debt should be treated no differently than a transaction effected by a single issuer. Under that logic, the issuance of publicly traded debt, say, by a corporate parent to acquire the debt of a subsidiary corporation from a third party should give rise to no more COD income than would a debt-for-debt exchange in which the subsidiary itself had issued the new debt instrument.[19]

On the other hand, we are uncomfortable recommending that proposed section 1274B apply to deemed redemptions described in section 108(e)(4), because we believe that

[19] Of course, the acquisition by the parent of debt for cash would not be treated as a debt-for-debt exchange under this logic, since that transaction would be equated with a cash redemption by the subsidiary, which would not be subject to proposed section 1274B. For the avoidance of doubt, we do *not* see any reason for applying proposed section 1274B to the deemed transaction where the issuer is treated as having redeemed its debt and reissued it to the acquiring related party under the "correlative adjustment" rules of Treasury regulation section 1.108-2(g)(1).

opportunities for abuse may arise when taxpayers are allowed to redistribute COD income among related parties. For example, consider a foreign corporate parent with a U.S. subsidiary. The subsidiary has outstanding publicly traded debt with an issue price of $100 and a current fair market value of $80. In that case, imagine that the foreign parent issues publicly traded debt, also with a face amount of $100 and a fair market value of $80, as consideration for the purchase of the subsidiary debt. Under the current operation of section 108(e)(4), the U.S. subsidiary would be treated as if it had redeemed its debt for $80, and reissued the debt to its parent with an $80 issue price. Accordingly, the subsidiary would recognize $20 of COD income. The foreign parent would have a basis of $80 in the acquired subsidiary debt, and the issue price of the foreign parent's newly issued debt would be $80.[20]

If the rules of proposed section 1274B were applied to change that outcome and treat the issue price of the foreign parent's debt as equal to its $100 face amount, then the domestic subsidiary would have no COD income, and the foreign parent would a have a basis of $100 in the debt of the subsidiary.[21] The subsidiary debt would continue to have an issue price of $100 following the deemed redemption. One could justify this result on the ground that the related-party group still owes $100 and thus should not be treated as if $20 of its liabilities had been forgiven. However, if the parent were to repurchase its newly issued debt for $80 at some point in the future, the group would have achieved a U.S. tax benefit by moving the recognition of the COD income offshore. Similarly, even within a related-party group consisting only of U.S. corporations, there may be ways for taxpayers to achieve an advantage by using the rules of section 108(e)(4) and proposed section 1274B to shift COD income from one member of the group to another (*e.g.*, if one member has net operating losses and thus can absorb COD income easily).[22] One could imagine policing such potential abuses ─ perhaps, in the above example, through some sort of agreement requiring the subsidiary to recognize COD income if the parent redeems debt within some period of time ─ but any such system is likely to create a considerable administrative burden. Furthermore, we suspect that the subsidiary faced with COD income in the above example would likely be able to avail itself of the benefits of proposed section 1274B by issuing its own debt to the market rather than having the parent issue debt. If the market saw some benefit in looking the parent's credit quality, then the parent presumably could issue a guarantee.

For the reasons discussed above, we recommend that related-party debt acquisitions described in section 108(e)(4) *not* be subject to proposed section 1274B. However, to the degree that issuers are required to recognize COD income by virtue of section 108(e)(4) in cases where they continue to owe the full amount of their original debt obligations, we believe that issuers should have the benefit of offsetting the COD income through OID deductions over the remaining term of the debt in question and that such benefit should not be limited by the AHYDO rules. In this regard, we suggest that the rules contained in section 163(e)(5)(F) be reinstated on a permanent basis to address this one case where a deemed debt redemption could give rise to COD income in the absence of a current reduction in the issuer's legal liability. Although section 163(e)(5)(F) was enacted as an emergency provision following the recent

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20 *See generally* Treasury regulation section 1.108-2.

21 *See* Treasury regulation section 1.108-2(f) and (g).

22 Even within a corporate group filing a consolidated federal income tax return, one could imagine situations where the shifting of COD income among members could matter (*e.g.*, one member is insolvent or is considering filing for bankruptcy, so that it would be avoid paying tax on COD income under section 108(a)).

economic crisis, we see no reason why the policy underlying that Code section should not be applied more broadly and permanently.

4. *Proposed Section 1037's Treatment of Debt Holders.*

We support the rule under proposed section 1037, which provides that "[n]o gain or loss shall be recognized to the holder of a debt instrument if such existing debt instrument is exchanged solely for a new debt instrument (whether by exchange or significant modification) issued by the same issuer." This rule is consistent with the proposals made in the 2011 ABA Report,[23] and that report does an excellent job of articulating the arguments in support of the rule.

From our perspective, the primary argument supporting the non-recognition rule for debt holders is that the rule is necessary in order to prevent proposed section 1274B from requiring debt holders to recognize non-economic income in situations that can be quite common in the distressed debt markets. Consider, for example, the case of an investor in the distressed debt markets that purchases a bond for its fair market value, which is at a steep discount to par ─ say, $400 for a bond with a face amount of $1,000. This steep discount is likely the result of concerns over the issuer's credit quality and the debt's ultimate collectability. In such cases, it of course would not be unusual for the issuer to undertake some kind of workout where the debt undergoes a significant modification giving rise to a deemed exchange described in proposed section 1274B. Assuming that the debt provides for adequate stated interest as required under section 1274 and was issued originally for par, proposed section 1274B would require the issue price of the modified debt instrument to be $1,000. In other words, the investor would be treated as having received a debt instrument worth $1,000 in exchange for a debt instrument with a basis of only $400, and thus would be required to include $600 of income in the absence of some non-recognition provision, such as section 354.[24] This result likely gives rise to the recognition of

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[23] In 2013 the ABA modified its recommendation regarding the tax treatment of debt-for-debt exchanges for holders ─ we suspect because of the perception that its original proposal now reflected in the Discussion Draft was unlikely to be accepted. *See* the 2011 ABA Report and "American Bar Association Section of Taxation Comments on the Camp Proposal to Reform the Taxation of financial Products," published by the American Bar Association Section of Taxation on December 30, 2013 (the "2013 ABA Report"), available at http://www.americanbar.org/content/dam/aba/administrative/taxation/policy/123013comments.authcheckdam.pdf. (last checked March 4, 2015). The 2013 ABA Report then modified the 2011 proposal by limiting non-recognition to cases where the maturity of the original debt instrument is not extended beyond the safe-harbor period under Treasury regulation section 1.1001-3(e)(3)(ii) (the lesser of five years or 50 percent of the original term). We do not view this additional limitation as an improvement. The premise of the basic non-recognition proposal is that the holder should not be taxed on value (equal to the face amount of debt) that has not been realized, and may not even exist outside of a tax fiction created by proposed section 1274B. For that reason, we believe that it is inappropriate to deny that relief to a class of debt holders merely because the maturity of their debt has been deferred beyond a certain point. We do not see how the deferral of a maturity date beyond a certain point is likely to make the holder's realization of value any more real than in other cases. On a net-present-value basis, certainly, the holder's right to collect principal in such cases is worth *less* than it otherwise might be.

[24] Of course, significant modifications of debt generally would qualify under current law for non-recognition treatment in cases where both the modified and unmodified debt qualify as "securities" issued by corporations within the meaning of corporate reorganization rules. To that extent, holders generally are protected from the recognition of gain until they dispose of the modified debt in a taxable transaction. Similarly, they would be prevented from recognizing a loss in respect of the debt modification. Accordingly, the primary effect of proposed section 1037 is to put all debt exchanges on the same footing, regardless of whether or not the debt instruments in question qualify as securities.

non-economic income because in most cases the deemed-issued debt would be expected to have a fair market value considerably less than its face amount.

In the example of distressed debt, therefore, proposed section 1037 operates particularly well and prevents an investor from recognizing income by reference to the face amount of a debt instrument that may never be paid in full.[25] The scope of proposed section 1037, however, extends beyond distressed debt, and the non-recognition rule would apply in any situation where a holder purchases any corporate debt (no matter how sound the issuer's credit) with a market discount (or premium), and the debt either undergoes a significant modification or is exchanged for other debt of the same issuer. In cases where a debt instrument's market discount is not due to problems with the issuer's credit quality, the non-recognition rule thus could, under current law, have the effect of enabling holders to defer the recognition of market discount indefinitely by agreeing to successive extensions. For example, if the holder of debt with market discount is not required under current law to take the market discount into taxable income until the debt matures, the issuer could defer the recognition of income by subjecting the debt to a significant modification and extending the maturity date. We note that this problem could be addressed by the adoption of proposed section 1278, discussed immediately below, which would require the current accrual of market discount, and our endorsement of proposed section 1037 therefore is conditioned at least in part on the assumption that proposed sections 1037 and 1278 both would be enacted as part of a new integrated statutory scheme.

B. New Rules for Market Discount Bonds

The Discussion Draft would modify the current rules applicable to market discount contained in sections 1277 and 1278. Under current law, if a debt holder purchases a debt instrument at a discount to its adjusted issue price, that discount constitutes "market discount." Unlike OID, market discount generally is *not* accrued into a holder's income on a current basis, unless the holder specifically elects such treatment. Market discount instead is

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Some of our members wished to note, however, that, when proposed section 1037 is combined with proposed section 1274B, the result is that neither the debt holder nor the issuer is likely to be taxed in respect of any debt-for-debt exchange or deemed exchange resulting from a significant modification. If one assumes that the proper model for taxing a debt-for-debt exchange is to view the issuer as if it had retired the old debt for cash and then re-borrowed that cash, then this result is arguably at odds with such a model. Specifically, when viewed from the perspective of that model, proposed section 1274B treats the issuer as redeeming its debt for a deemed cash payment that may be in excess of the debt's actual fair market value, thus allowing the issuer to avoid COD income. Section 1037, however, provides that the deemed excess will *not* result in taxable income to the debt holder in our example above. Compared to the current law result where issuers would recognize COD income even in cases where the debt holders are allowed nonrecognition treatment under current section 354, this result is less favorable to the fisc.

[25] As discussed above, under section 1274(b)(3) and Treasury regulation section 1.1274-3, the issue price of a debt instrument may be deemed to be its fair market value, regardless of whether the debt instrument is publicly traded, in certain "abusive" situations where there is a concern that issuers may manipulate the rules of section 1274 in order to achieve tax avoidance. In the past, holders of recently purchased debt that was then the subject of a debt-for-debt exchange hoped to use that rule to achieve a fair-market-value issue price for their newly issued debt. In 2012, however, the Treasury finalized Treasury regulation section 1.1274-3(b)(4), which expressly states that the anti-abuse rule under section 1274(b)(3) does not apply to debt-for-debt exchanges (including significant modifications giving rise to deemed debt-for-debt exchanges under Treasury regulation section 1.1001-3). In the Preamble to the regulations, Treasury acknowledged the fact that this across-the-board exclusion of debt-for-debt exchanges may create distortions in situations where the issuer is in financial distress, but indicated that "distressed debt situations are subject to a separate guidance project." *See* TD 9599, 2014-40 I.R.B. 417.

taxed as interest income only when actually paid to the holder (either at the maturity of the debt instrument, or upon a subsequent disposition of the instrument, to the extent the market discount has already accrued at the time of the disposition). If a holder elects to take market discount into income currently, then the holder may elect either to accrue market discount on a straight-line basis with daily ratable accruals, or to use the constant-yield method applicable to OID.

The Discussion Draft would change the current rules by inserting a new section 1278 into the Code that would require market discount to be accrued currently on a constant-yield basis, effectively putting market discount under the same mandatory accrual regime that currently applies to OID.[26] Current accruals on market discount bonds, however, would be subject to a cap, which is *the excess of* (i) the "maximum accrual rate" of the bond multiplied by its adjusted basis at the beginning of the relevant accrual period *over* (ii) the sum of all qualified stated interest and OID generated by the bond and allocable to that accrual period. In other words, the aggregate amount of interest income generated by the bond from OID, currently accrued market discount and coupon interest together cannot exceed the maximum accrual rate. The "maximum accrual rate" in turn is defined as *the greater of* (i) the debt's yield to maturity (determined as of the issue date) plus five percentage points and (ii) the AFR for such debt (determined as of the acquisition date) plus ten percentage points.

As a general matter, we support the notion of requiring current accrual of market discount because we acknowledge that market discount and OID are economically similar and should be taxed under similar rules. Our understanding is that the current regime, which was created in the 1980s, is the result of a time when computing power was much less readily available than it currently is. Accordingly, the requirement that bond holders calculate current accruals in respect of market discount was considered to be too onerous. Today, however, the widespread availability of sophisticated computer programs that can perform complex financial calculations quickly belies this concern as a justification for treating market discount and OID materially differently from one another. In fact, we understand that financial institutions and other taxpayers that trade and invest heavily in debt obligations routinely elect to accrue market discount on a current basis. Those debt holders generally do not differentiate market discount from OID for general accounting purposes, and to the extent the debt holders are not on mark-to-market tax accounting, the tax deferral otherwise available for market discount typically is not worth the administrative complexity of keeping track of market discount separately from OID. The remainder of the discussion of proposed section 1278 in this Report, therefore, is concerned primarily with areas where we believe proposed section 1278 might include rules to address certain special contexts, such as highly speculative debt instruments and pools of debt obligations.

1. *Applying Market Discount Rules to Highly Speculative Instruments*

The accrual cap in proposed section 1278 raises certain significant policy issues in the case of distressed, or highly speculative, debt. Namely, once the holder of a debt instrument is no longer certain of receiving full payment of the amounts owed under the instrument (or is

[26] Specifically, proposed section 1278 would require market discount to accrue by reference to the daily portions of OID that would have accrued under section 1273 if the debt instrument in question had been issued originally to the taxpayer on the date the taxpayer acquired such debt instrument, for an issue price equal to the taxpayer's basis in the debt instrument.

virtually certain *not* to receive full payment), does it make sense to force the holder to accrue income in respect of the instrument, and if so, what are appropriate amounts to be accrued?[27]

As an initial matter, we understand that the policy underlying the cap is to differentiate returns that are economically similar to interest from other returns that are more speculative. If a bond is trading at such a steep discount that its yield to maturity has become greater than the yields used to set the cap, then it is likely that the credit quality of the issuer has been seriously impaired, and that the increased yield represents a risk premium in respect of amounts that ultimately may not be collectible. The Discussion Draft implicitly takes the position that any return on such a steeply discounted instrument should be bifurcated into (i) market discount accruing up to the cap, on the one hand, which is properly taxed under the timing rules applicable to OID, and (ii) excess amounts of market discount, on the other hand, which represent a speculative return that should not be accrued into income currently or treated as ordinary income.

This bifurcation approach introduced by the cap, however, constitutes a significant departure from current law, where taxpayers using the accrual method of tax accounting generally are required to accrue payments in full unless they can demonstrate that a payment is sufficiently speculative to be exempted from accrual altogether under the common law "doubtful collectability" doctrine.[28] The Service has taken the position that the doubtful collectability doctrine does not apply to OID, on the grounds that section 1272 requires the accrual of OID on its face and thus overrides the common law rule.[29] It seems likely, therefore, that the Service would take the view that proposed section 1278 similarly would override common law and prevent taxpayers from avoiding the accrual of the capped amount of market discount in respect of highly speculative debt. Thus, we believe that proposed section 1278 may represent a view that (i) the requirement to accrue market discount should apply to all debt instruments, regardless of how speculative the ultimate payout on the instrument may be, and (ii) it is appropriate to determine the amount of accrual by reference to a fixed formula, again without any inquiry into the specific facts and circumstances of a particular debt issuance.

The bifurcation approach of proposed section 1278 has the advantage of providing an easily administrable rule that prevents accruals of market discount from exceeding a certain yield, which yield presumably is intended to demarcate the limits of a normal time-value-of-money return. In addition, the bifurcation approach avoids the need to determine

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27 Many of the issues discussed in this Report related to distressed debt are also discussed in our 2011 Report No. 1248 entitled "Report of the Tax Section of the New York State Bar Association on the Taxation of Distressed Debt," which was submitted on November 20, 2011 (the "2011 Distressed Debt Report"), available at http://old.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1248report.pdf (last visited February 23, 2015).

28 *See e.g., Corn Exchange Bank v. U.S.*, 37 F.2d 34 (2d Cir. 1930); *Atlantic Coast Line Railroad Co.*, 31 B.T.A. 730 (1934), *acq*., XIV-2 C.B. 2; *American Central Utilities Co.*, 36 B.T.A. 688 (1937); *European Amer. Bank & Trust Co. v. U.S.*, 20 Cl. Ct. 594 (1990); *Electric Controls & Service Co., Inc*., T.C. Memorandum 1996-486. *See also* Rev. Rul. 80-361, 1980-2 C.B. 164.

29 *See* TAM 9538007 (Sept. 22, 1995). Of course, a contrary view is that section 1272 merely puts debt holders on the accrual method of tax accounting for OID, and thus incorporates the common law principles that apply to accrual tax accounting generally.

whether any specific payment is sufficiently speculative to warrant exemption from accrual,[30] and acknowledges that a debt instrument may be speculative to some degree while still providing the holder with a reasonable expectation of a debt-like return. Also, the accruals will be proportionate the holder's purchase price ─ very low purchase prices will generate correspondingly low market discount accruals, which may even reach zero if the stated interest on the debt instrument in question is large enough to account for the capped yield entirely.

On the other hand, the bright-line rule in proposed section 1278 can be arbitrary in setting a fixed return that is supposed to represent a "normal" debt-like return in all circumstances. The rule also ignores the central observation underlying the "doubtful collectability" doctrine ─ that some debt instruments can become so speculative that it is no longer appropriate for holders to be taxed on any current expected time-value-of-money return. At some point, for example, a debt instrument becomes nothing more than the ability to participate on a creditors' committee in bankruptcy and to find ways to maximize a potential payout, which payout is likely to be considerably less than the debt instrument's full face amount plus accrued interest. In such cases, debt instruments begin to resemble equity in their economic characteristics, and it may be appropriate to allow taxpayers to avoid accrual altogether, as they can under current common law.

Ultimately, we were unable to reach a consensus on the question of whether the proposed market discount rules should be made to work in conjunction with the doubtful collectability doctrine or should instead replace the doctrine. We believe, however, that it is important that any legislation choose an explicit approach, as silence on the point would likely lead to a considerable amount of confusion in the markets and to taxpayers' adopting *ad hoc* approaches to the question. We therefore recommend that any final rule requiring current accrual of market discount expressly address the question of how that rule is intended to interact with the doubtful collectability doctrine.

In considering how, and whether, the doubtful collectability doctrine should continue to apply following an adoption of proposed section 1278, it is also useful to consider whether there should be a distinction between the investor that purchases a debt instrument initially at a discount so steep as to suggest that any payout on the instrument is highly speculative and the investor that purchases a debt instrument, say, at a less extreme discount to face value only to see the value of the instrument later fall to such a point as to suggest that any future payout is highly speculative. In the first case, the investor presumably purchases the instrument with full knowledge of the issuer's financial distress and anticipates some kind of profit from the purchase that arguably could be appropriate for current accrual. In the second case, there is a much stronger argument that the investor has undergone an economic loss form the deterioration of the debt in its hands, or at least has been forced to revisit prior expectations about the ultimate collectability of the instrument. If the first investor is forced to recognize the low market discount accruals required by applying the rate to its low purchase price, it arguably is appropriate to require the second investor to continue to accrue market discount by reference to its much higher purchase price. On the other hand, a rule that would allow the second investor

[30] As a practical matter, we understand that many investors in distressed debt take the view that the doubtful collectability doctrine precludes accrual in cases where a debt instrument is purchased for less than half of its face amount. We further understand that taxpayers taking this approach generally do not accrue income on such instruments for financial accounting purposes either.

to set its accrual rate by reference to the current fair market value of the debt raises the questions of when such a "write down" of the debt should be allowed, and of whether this more complicated rule is superior to the current doubtful collectability regime.

2. *Character Matching.*

We believe that the proposed revisions to the market discount rules present an opportunity to revisit the rules applicable to the character of gain or loss realized in respect of OID and of currently accrued market discount. Under the current OID regime and the proposed market discount regime, debt holders accrue OID and market discount on a current basis as ordinary income, and their bases in the relevant debt instruments increase accordingly. The mismatch arises when a holder of an OID or market discount bond fails to realize OID or market discount that it has previously accrued ─ *e.g.*, because the debt is sold at a loss, or the issuer is unable to pay the principal amount in full. In such a case, the holder generally will be able to recognize only a capital loss in respect of the debt, which is unlikely to compensate the holder for the prior accrual of ordinary income that was never in fact received.[31]

In order to address this issue for currently accrued market discount, the Discussion Draft contains a "character matching" rule under which: "[s]o much of any loss recognized by the taxpayer on the disposition of a market discount bond as does not exceed the aggregate amounts included in the taxpayer's income [as currently accruable market discount] with respect to such bond shall be treated . . . as an ordinary loss."[32] We support this rule because we believe that it goes a long way to alleviate distortions in a taxpayer's taxable income by matching the character of income with what economically are offsetting losses.

There is one issue raised by the character matching rule, however, that is worth noting. The strongest argument in support of the character matching rule stems from an analogy of the failure to realize full value for previously accrued market discount to the failure to receive any other payment that has previously been included in income. Under the argument, the debt holder was promised a certain payment, which was accrued, and the accrual should be reversed through an ordinary loss when the payment fails to materialize. This analogy applies only partially to a decline in value of a debt instrument, however, because such a decline may not indicate that investors are in any danger of not being paid what they are owed. Specifically, a rise in interest rates would be expected to cause a fall in the value of fixed-rate debt instruments, no matter how high the credit rating.

As a theoretical matter, one could imagine a regime where a decrease in the value of a debt instrument is allocated between the effects of interest rate fluctuations and changes to the issuer's credit quality, and where losses on the disposition of such debt accordingly are treated partially as capital and partially as ordinary. Such a regime, however, might be difficult to implement in practice, unless it were applicable only to losses realized at maturity of an instrument (which would be due entirely to changes in credit quality). Furthermore, the effects of allowing the seller of a high-quality debt instrument to benefit from the matching rule will be

[31] A similar taxpayer-favorable mismatch could arise in the case of a holder that is allowed to amortize premium or acquisition premium in respect of a debt instrument, and then is able to sell the debt at a capital gain with no need to recapture the amortization.

[32] Proposed section 1278(d)(3).

mitigated to the extent that the subsequent purchaser also is required to accrue market discount in accordance with proposed section 1278.

Because we generally support the character matching rule, we recommend that consideration be given to whether this matching principle might appropriately be expanded to OID accrual in addition to market discount. As mentioned above, proposed section 1278 is premised on the notion that market discount and OID are economically equivalent from the vantage point of the debt holder, and that same logic would suggest that the character matching rule should apply equally to both types of income.

The propriety of matching the character of OID income and related loss is already acknowledged in the current rules governing CPDIs. The CPDI rules provide that taxpayers are allowed an ordinary loss on disposition of a CPDI to the extent that the basis in the CPDI represents amounts previously accrued and taken into ordinary income. Similarly, if a CPDI holder includes contingent interest into income in amounts greater than the interest ultimately paid, the holder is entitled to a "negative adjustment," which functions effectively as a reversal of the prior accrual.[33]

There is one distinction between OID and market discount that weighs in favor of limiting the character matching rule only to market discount: OID inclusions in the hands of the holder are matched by ordinary interest deductions to the issuer, while market discount inclusions are not. For that reason, one might argue that allowing an ordinary deduction at the holder level might be some form of "double dipping" because it creates two ordinary deductions (rather than an ordinary deduction for the issuer and a capital loss for the holder) for one OID inclusion.[34] That objection, however, is not persuasive if one assumes that an ordinary loss claimed by a seller of an OID instrument will be offset by further income inclusions of OID/market discount on the part of the purchaser ─ in that case, there would be two sets of OID/market discount inclusions to match the two ordinary deductions. With that assumption, income and deductions are matched, even though an immediate ordinary loss on sale is offset by OID and market discount accruals taken into account over time.[35] One final point to note is that, even where all investors in the relevant debt are U.S. taxable entities, the result described above (and our support for expanding the character matching rule to OID) assumes that any character

33 Under Treasury regulation section 1.1275-4(b), the holder of a CPDI is required to include as interest income the amount of projected payments on such CPDI in each taxable year. If the amount of projected payments exceeds the amount the holder actually received in the taxable year, the holder is permitted a net negative adjustment to offset future interest income with respect to the CPDI. The net negative adjustments can be carried forward until the disposition or retirement of the CPDI. Any loss realized upon a sale or disposition of the CPDI will be recharacterized as ordinary loss to the extent of the total amount of interest included into the holder's income (reduced by the total net negative adjustments the holder has already taken into account as ordinary loss).

34 Issues related to character matching are less likely to lead to abuse in the context of CPDIs where all gain and most loss is treated as ordinary.

35 It is worth noting that this assumption often may prove to be false due to the large number of investors in U.S. corporate debt obligations that are either tax-exempt or foreign entities that would *not* take OID or market discount into taxable income. The distortions created by such investors are widespread throughout the tax system, however, and are not qualitatively different in this context from the distortions created any time such investors purchase debt and do not pay tax with respect to the issuer's tax-deductible interest payments.

matching rule for OID be adopted as part of a package along with the market accrual rules of proposed section 1278.[36]

3. *Aggregation Rules for Distressed Debt Portfolios.*

The character mismatch and accrual issues discussed above become more pronounced in the case of certain portfolios of distressed debt, because portfolios often function effectively as a mass investment where a failure to net losses and gains realized within the portfolio can give rise to non-economic tax results. Consider the case of an investor who purchases numerous distressed debt issues (*e.g.,* credit card receivables) for pennies on the dollar (*e.g.,* at a 90 percent discount) in the expectation that many of them will provide little or no cash flow but that others will provide payouts sufficient to produce an adequate overall return on the portfolio as a whole. In such a situation, the investor views the entire portfolio as if it were a single investment, with a single purchase price and a single return. Consider, however, the result that can arise from treating the individual debt instruments on a stand-alone basis. Imagine the investor's portfolio consists of only two bonds, each with a face amount of $100 and each with a fair market value of $10 (so the investor pays $20 for the "portfolio"). Assume that the investor accrues $10 of market discount in respect of both bonds before one is cancelled with no payout whatsoever, and the other is redeemed for $20. As an economic matter, the investor has made an investment of $20 and received a ultimate payout of $20, and thus has realized no gain or loss (other than the loss of the time value of money) in respect of the portfolio as an economic matter.

As a tax matter, on the other hand, the investor has accrued $20 of market discount as ordinary income and, assuming the proposal regarding character matching discussed above is adopted, will have an ordinary loss of $10, effectively reversing the market discount accruals on the bond that turned out to be worthless. The investor also will have an additional $10 capital loss in respect of that bond. Unless the investor is able to offset the $10 capital loss against the $10 of market discount accrued in respect of the bond that was redeemed for $20, the investor will have net taxable income of $10 in respect of an investment that economically produced no income.

We believe that it may be appropriate for investors in pools of distressed debt of the sort described above to treat their portfolios effectively as if they were a single investment, and that result could be achieved by allowing capital losses realized in such portfolios to be ordinary to the extent of the aggregate amount of market discount accrued in respect of the portfolio. In this way, losses in respect of the losing portfolio instruments could offset income in respect of the winning instruments.

In considering how such an aggregation rule might operate as a practical matter, we believe that it should apply only to portfolios that are generally static and in respect of which debt instruments are held to maturity (or cancellation).[37] Otherwise, we believe that there would be too many opportunities for taxpayers to "game the system" by adding loss-generating assets to

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[36] To the degree that OID ultimately is not paid at maturity, the issuer would then realize COD income to match the holder's ordinary deduction.

[37] To the extent it were deemed appropriate to make such treatment elective, any election should be irrevocable as to any specifically identified portfolio in respect of which it is made.

portfolios in order to offset gains on investments that appear less speculative than they might have at the time of the taxpayer's initial investment.

Another complication arising from an aggregation rule relates to the matching of gains and losses over multiple taxable years. If the premise of an aggregation rule is that the portfolio should be treated as much like a single, integrated instrument as possible, then it follows that there should be some method to ensure that net losses (income) generated within the portfolio for any specific taxable year should be offset against net income (losses) arising in subsequent years. This in turn implies that net income or loss arising from the portfolio for a specific taxable year should not be available to offset items arising outside of the portfolio, at least until is it clear that such net income or loss will not be offset by future items arising later from within the portfolio.

The Discussion Draft appears to recognize the need for an aggregation rule of the sort discussed above, but is not entirely clear on the point. Specifically, the Discussion Draft states, in proposed section 1278(c)(3), that "[i]n the case of debt instruments to which section 1272(a)(6) applies, rules similar to the rules of such section shall apply for purposes of determining the daily portions of market discount." We suspect that, by invoking section 1272(a)(6), the drafters intended to treat pools of debt instruments as aggregate assets. However, what section 1272(a)(6) does as a technical matter is to require OID on a pool of debt instruments to be computed taking account of a prepayment assumption, with adjustments to account for actual prepayments. A prepayment assumption makes sense only as applied to a pool, but strictly speaking, once computed it can be applied to individual loans in a pool. There are no regulations under section 1272(a)(6), so the application of the rule is not entirely clear. For that reason, we believe that it would be helpful to clarify that the intention of the reference to section 1272(a)(6) is to treat pools of receivables and debt instruments as single aggregate assets, and perhaps to the formulate the intended operation of the aggregation rule in somewhat more detail than the Discussion Draft currently does.

III. **Derivatives Proposals.**

The derivatives proposals of the Discussion Draft are set forth in proposed new sections 485 and 486. Section 485 provides that for income tax purposes, any "derivative" held by a taxpayer at the close of the taxable year is treated as sold for its fair market value (a "mark to market" regime), and that all income, gain, loss and deduction with respect to the derivative are treated as ordinary income or loss. While the proposal appears to be intended to affect solely the timing and character of income and loss from derivatives, any derivative within its scope would not be treated as a capital asset, which could have broader consequences.[38]

Section 486 defines the term "derivative" to mean any contract, "the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to" any corporate stock, partnership interest, trust interest, evidence of indebtedness, real property (subject to certain exceptions), actively traded commodity, any currency, and "any rate, price, amount, index, formula, or algorithm" or any other item

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[38] See Section 3401(f)(6)(A) of the Discussion Draft (amending definition of capital asset in section 1221). See the discussion in Part III.B.4, below.

prescribed by the Secretary. Contracts included in the definition of a “derivative” include any option, forward contract, futures contract, short position, swap or similar financial instrument. This definition is intended to have, and has, very broad application, including both instruments typically thought of as financial instruments and others that are not, for example, merger & acquisition stock purchase contracts, equity-linked employee compensation, and joint venture agreements.

Mark-to-market applies only to derivatives, and not to shares of stock, bonds or other debt instruments, commodities or other “physical” assets, unless they are part of a straddle, subject to certain exceptions. In the case of such a mixed straddle – broadly speaking, any transaction in which a physical asset hedges or is hedged by one or more derivatives – all positions in the straddle are subject to the mark-to-market regime. Any built-in gain (but not loss) on the physical asset when it becomes part of the straddle is accelerated and taken into account at that time, subject to certain limited exceptions.

The Discussion Draft also amends or repeals a number of existing provisions, including section 475 (mark-to-market rules for dealers and traders in securities and commodities), section 1092 (the straddle rules), and section 1256 (mark-to-market and capital gain/loss holding period rules for regulated futures contracts and other “section 1256 contracts”). The derivatives proposals are described in more detail in connection with the discussion below.

The remainder of this part addresses whether the proposed mark-to-market regime provides a better approach to taxing derivatives than current law; the scope of the mark-to-market proposal and its character rule; the application of the mark-to-market proposal to hedges of capital assets; the treatment of debt with embedded derivatives; and the treatment of derivatives on an issuer’s stock.

A. Comparison of the Discussion Draft’s Mark-to-Market Proposal and Current Law, and Proposed Investor Mark-to-Market Election

1. *Comparison with Current Law*

By way of background, it may be useful to review briefly the history of mark-to-market rules for U.S. income tax purposes.

- The appropriateness of marking capital assets to market first emerged as an issue in the 1920s, in the form of requests by commodities dealers that were marking their inventory to market to be permitted to mark related hedges such as commodity futures contracts to market as well. After initial resistance, the IRS concluded that marking hedges to market under those circumstances clearly reflected income.[39]

[39] Appeals and Review Memorandum 100, III-3 C.B. 66 (1920) (rejecting attempts by commodities dealers to include unrealized gains and losses from future contracts as adjustments to their mark-to-market inventory values, but allowing the dealers to adopt a general mark-to-market accounting method for futures contracts used as hedges); Appeals and Review Memorandum 135, 4 C.B. 67 (1921) (permitting commodities dealers to adopt a

- More than half a century later, in 1981, Congress mandated that regulated futures contracts be marked to market for tax purposes, in section 1256, in order to address abusive transactions that also involved offsetting positions, this time in long and short futures positions in commodities.[40] Section 1256 was later extended to certain other derivatives, mostly exchange-traded ones.

- Mandatory mark-to-market was extended in 1993 to dealers in securities and derivatives under section 475, a rule that took into account the ease with which securities dealers could realize losses on their positions by selling them at year-end, and also reflecting again the conclusion reached in the 1920s that marking to market hedges of inventory that turns over rapidly is the method of accounting that most clearly reflects income.[41] Section 475 later was amended to provide a mark-to-market election to dealers in commodities, and to traders in securities or commodities.

- Section 1296 provides a partial mark-to-market election for taxpayers that own marketable shares in a passive foreign investment company.

- In 2004, the IRS proposed regulations providing for a taxpayer election to mark to market notional principal contracts with contingent nonperiodic payments.[42]

Mark-to-market rules thus far, therefore, have been applied to one or both of (a) highly liquid, readily valued assets, and (b) trading or dealing books with multiple long and short positions, typically ones that are frequently adjusted during the course of a taxable year.

In evaluating whether the proposed mark-to-market regime is an improvement over current law, we have taken into account a number of questions: (1) Does it improve the consistency, administrability and economic accuracy of the taxation of financial instruments?; (2) Are the new issues that it would raise easier to deal with than the issues that taxpayers and the government must deal with under current law?; and (3) Should it apply, as proposed, to all taxpayers or should it be limited in one or more ways to specific types of fact patterns or taxpayers? We are mindful that any design for the taxation of complex instruments will raise issues, and assume for purposes of this analysis that the technical issues discussed later in this report will have been addressed in some satisfactory manner.

Potential advantages of the proposed regime include:

- *Economic accuracy.* The proposed regime would harmonize the imposition of tax (or relief from taxation) on derivatives positions with

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comprehensive mark-to-market accounting system for open hedge contracts). This remains the view of the Service today. See Revenue Ruling 74-223, 1974-1 C.B. 23 (restating A.R.M. 135).

40 Section 503 of the Economic Recovery Tax Act of 1981 ("ERTA"), P.L. No. 97-34, 97th Cong. 1st Sess. (August 13, 1981).

41 H.R. Rep. No. 103-111, 103d Cong. 1st Sess. 661 (May 25, 1993).

42 Proposed Treasury regulation section 1.446-3(i), Notice of Proposed Rulemaking, *Notional Principal Contracts: Contingent Nonperiodic Payments*, 2004-1 C.B. 655.

changes in economic wealth.[43] The history of mark-to-market taxation summarized above illustrates this point. At least in cases where taxpayers have offsetting positions, particularly when they turn over rapidly, mark-to-market taxation can be the best method, and sometimes the only feasible method, available for ensuring that taxpayers are subject to tax on net income that matches their economic income. Similarly, in cases where taxpayers hold liquid positions for relatively short periods of time, as with traditional futures contracts and the inventory of a securities dealer, mark-to-market can provide an accurate measure of changes to the value of a taxpayer's assets without imposing significant liquidity costs on taxpayers. The fact that securities traders, and commodities dealers and traders, sought the right to elect mark-to-market treatment demonstrates the potential benefit to taxpayers of such a system. Applying mark-to-market taxation to a wider set of transactions could similarly improve the accuracy of the incidence of taxation.

- *Reducing complexity*. The choice of mark-to-market/ordinary treatment for derivatives could provide simplification by eliminating many issues that arise under current law. For example, it would no longer be necessary for many purposes to determine when a realization event has taken place, so that for example it does not matter whether a particular transaction constitutes a "sale or exchange." It would also no longer be necessary to limit the deduction of losses from capital assets subject to the mark-to-market regime.

  The taxation of derivatives under current law consists of a hodgepodge of common law and complex statutory rules addressed to specific transactions or products. This collection of rules is difficult to navigate without the assistance of an expert, which creates risks for taxpayers seeking to comply with the law and risks for the government because it is difficult for both taxpayers and revenue agents to apply them. Moreover, because the rules have been adopted at different points in time to address particular transactions, they overlap in some respects and have gaps in others. Replacing this system with a single thoughtfully designed and clear one that sweeps in a broad range of transactions could both reduce administrative costs and improve compliance.

- *Consistency*. The proposed regime would eliminate differences in tax rules applicable to similar economic positions. Under current law, similar economic positions can be created through different combinations of derivatives and other positions, each of which may be subject to different

[43] For discussions of the measurement of taxable income by reference to changes in economic wealth, see generally Robert Murray Haig, *The Concept of Income–Economic and Legal Aspects*, in THE FEDERAL INCOME TAX (Robert Murray Haig ed., 1921); Henry C. Simons, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY (1938).

rules under current law.[44] These distinctions may be formalistic, or may treat risks that are on different points on a single continuum as different in kind. A mark-to-market regime would eliminate the relevance of form and treat similar transactions within its scope similarly.

- *Symmetry between dealers and customers*. A related point is that requiring non-dealers to mark their derivatives positions to market would create a consistent method of accounting for securities and commodities dealers and their U.S. taxable customers. All other things being equal, the application of symmetrical rules to the parties to a transaction tends to minimize the risk of whipsaw or arbitrage, and to align the parties' collective incentives with good tax policy.

- *Book-tax conformity*. Under U.S. generally accepted accounting principles ("GAAP"), derivatives typically are required to be marked to market, unless they qualify for hedge accounting. For those taxpayers that mark derivatives positions on their books to market, a mark-to-market tax regime offers the potential to eliminate book-tax differences that can give rise to random and unpredictable tax effects on their financial earnings. Eliminating book-tax differences also reduces the incentive for taxpayers to undertake tax-advantaged transactions that have no effect, other than reducing taxes, on their financial statements.[45]

- *Reducing arbitrage opportunities.* Timing and character mismatches provide opportunities to sophisticated taxpayers to transform ordinary income into capital gain, to transform capital losses into ordinary losses, and to defer income or accelerate losses, or the reverse where it is favorable to do so, for example to accelerate income in order to refresh an expiring loss. Many of the specific rules referred to above are intended to prevent such transactions. Because timing and character mismatches are inherent in existing law, however, it is difficult to eliminate such opportunities. For example, a taxpayer may enter into a swap with the intention of making payments that give rise to ordinary losses on a current basis, and disposing of the swap at a capital gain if it appreciates in value.

- *Efficient use of resources*. The proposed regime would eliminate the need to police new derivatives transactions to prevent abuse. In recent decades, derivatives have played a prominent part in many transactions challenged by the government as, and held by the courts to be, abusive tax shelters.

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[44] For a discussion of how economically identical derivative transactions can lead to different tax consequences, see Randall K.C. Kau, *Carving Up Assets and Liabilities – Integration or Bifurcation of Financial Products,* TAXES, Dec. 1990, at 1003–14.

[45] Concern for the potential abuses that arise from book-tax differences has long motivated the IRS to require reporting of transactions giving rise to them. Until 2006, transactions with "significant" book-tax differences were reportable transactions, *see* Notice 2006-6, 2006-1C.B. 385. Book-tax differences continue to be highlighted on Schedule M-3 to IRS Form 1120, which requires corporations with assets of $10 million or more to reconcile book and taxable income, and similar schedules for certain other taxpayers.

Avoiding the considerable private and public resources devoted to constructing, evaluating, challenging and litigating such transactions would improve public welfare.

- *Limited effect*. The realization method of accounting that is the basis of current law is founded on significant policy and practical considerations. Limiting the scope of a mark-to-market regime so that it affects only a relatively small and sophisticated group of taxpayers that transact primarily with each other and that are better able to handle liquidity and valuation issues than the vast majority of taxpayers reduces unwanted side effects. Similarly, limiting mark-to-market treatment to a relatively exotic form of financial instrument, as opposed to conventional stocks and bonds, limits the distributional, administrative, capital markets and state tax consequences of the new regime.

Potential disadvantages of the proposed regime include:

- *Valuation, liquidity, impermanence.* The foundations of the conventional realization method of accounting remain applicable, to greater or lesser degree:
    - A mark-to-market regime places enormous pressure on the ability to value positions accurately. Outside the realm of actively traded products, current law's experience with valuation issues – notably, in the transfer pricing and estate tax areas – does not inspire confidence. Even in the case of actively traded instruments, there have been fundamental disagreements between taxpayers and the IRS about valuation. (See Part III.B.1, below.)
    - The lack of cash available to pay tax on gains, and the impermanence of those gains, also raises questions about the fairness of a mark-to-market regime. This concern is greatest for non-actively traded products.[46] As the Joint Committee on

[46] Some commentators have suggested that a mark-to-market regime that applies to non-actively traded instruments may raise Constitutional issues. See *Eisner v. Macomber*, 252 U.S. 189 (1920) (declaring that, under the Sixteenth Amendment, "a growth or increment of value in the [taxpayer's] investment" could not be considered income until it was severed from capital); *Charles L. Murphy v. United States*, 992 F.2d 929 (9th Cir. 1993) (upholding the constitutionality of mark-to-market accounting for futures contracts under section 1256, because, under the doctrine of constructive receipt, "the taxpayer who trades futures contracts receives profits as matter of right daily"). Other commentators have concluded that the realization method is founded on administrative convenience rather than Constitutional concerns. *See* David S. Miller, *Barlett, Realization and the Constitution* (Jan. 7, 2014), *available at* http://taxprof.typepad.com/taxprof_blog/2014/01/miller-.html#more (last accessed on March 13, 2014) (citing *Helvering v. Horst*, 311 U.S. 112 (1940) (realization requirement is ''founded on administrative convenience''). We do not address any Constitutional issues.

A separate issue is raised for regulated investment companies ("RICs") and other quasi-pass-through vehicles that must distribute a minimum percentage of their taxable income in order to retain their tax-favored status. Mark-to-market income that is not accompanied by cash effectively would require a RIC to make cash distributions to investors out of principal. Similarly, if a RIC has ordinary income or loss from its derivatives positions, and capital gain or loss from its investments, the RIC may well be required to distribute amounts that do

Taxation has observed, it is far more common than in the past for derivatives to provide for collateral equal to their fair market value. However, the scope of the term "derivative" in section 486 is far broader than the types of transactions described by the Joint Committee.

- Even when a taxpayer has received cash collateral, the fact that the market value of a derivative changes daily means that the taxpayer may be required to repay it at any time, unlike the case where the taxpayer has locked in the cash receipt by selling or otherwise disposing of the position.

- Requiring a taxpayer to pay taxes out of cash collateral it has received has the undesirable effect of effectively leaving the taxpayer undercollateralized. This is contrary to the thrust of many of the changes to the derivatives market required by Dodd-Frank.[47]

- *Disconnect with underlying assets*. Marking derivatives to market but not the underlying securities or other assets creates a disconnect with the tax treatment of the underlying assets, with potential policy and practical implications, at least where those assets are themselves readily valued and easy to dispose of for cash. As noted above, mark-to-market rules in the tax law derive from ordinary business transactions in which taxpayers were hedging their inventory, because marking hedges to market under those facts was the only manner in which the taxpayer could clearly reflect its income.[48] Expanding mark-to-market for stand-alone derivatives creates a radically different tax regime for two economically similar transactions, namely a "long" position in the derivative and a "long" position in the underlying asset. If marking derivatives to market is intended to more clearly reflect income, that suggests that failing to mark actively traded securities and commodities to market does not clearly reflect income.

- *New arbitrage/whipsaw potential.* The creation of a mismatch in the tax treatment of derivatives and underlying assets may create the potential for

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not reflect economic income. In both cases, RIC investors will be subject to taxation on cash that economically constitutes a return of principal. We do not otherwise discuss the special issues applicable to RICs and other vehicles of that kind.

[47] These points are also true for futures contracts that are subject to section 1256's mark-to-market rules. Historically, however, the only meaningful trading in futures contracts was in contracts that had a term of less than a year, and often no more than three months. The fact that futures contracts were very short-term alleviated the concerns expressed in the text. For example, built-in gain at year-end was more likely to correspond to gain on termination or disposition of the futures contract, and requiring the taxpayer to pay taxes based on the year-end value was less likely to leave the taxpayer under-collateralized, than would be the case under the Discussion Draft's proposal.

[48] *See, e.g.,* H.R. Rep. No. 103-111, 103d Cong. 1st Sess. 661 (May 25, 1993) (noting that "that the mark-to-market method most clearly reflects [securities dealers'] income").

either abuse or whipsaw, in circumstances where taxpayers have the flexibility to take on a specific economic exposure in different ways. The fact that gains or losses on underlying assets are capital while income and losses from derivatives are ordinary gives rise to similar potential for either abuse or whipsaw.

- *Hedging issues.* Because derivatives are widely used as hedges, it is essential to have a workable regime for transactions in which derivatives hedge capital assets. We believe the Discussion Draft's proposal needs significant improvement in order to meet that standard (See Part III.C, below).

- *New line-drawing required.* The broad scope of the proposed definition of derivative means that it will be necessary to add an array of carve-outs to the rules in order to ensure that they do not apply to transactions or taxpayers not intended to be affected. For example, some commentators have already identified situations where the regime would apply to individuals that are not (very) high net-worth taxpayers, who we understand generally were not viewed as the type of Wall Street speculators that the Discussion Draft is principally intended to affect. Prior experience with broadly drafted legislation suggests that it is likely that the need for additional carve-outs in order to conform to Congress's intent will become apparent only after the legislation is enacted.

- *Cliff effect.* Regardless of the scope of a new mandatory mark-to-market regime, the creation of a fundamentally different regime for the taxation of derivatives will place great pressure on drawing lines between what is subject to the regime and what is not. For example, it will be important to be able to distinguish between a debt instrument and a derivative. These are issues that taxpayers wrestle with today, for example in connection with structured notes and in connection with swaps.[49]

Members of the Tax Section's Executive Committee had widely divergent views as to how to evaluate these competing considerations. Some members thought that, whatever the theoretical merit of a mark-to-market regime for derivatives, the potential disadvantages described above would result in a system that did not improve on current law. That is, the disadvantages of current law would be replaced by other, equally significant, disadvantages, including that the new rules would themselves be very complex. They thought that, in the

[49] A structured note that guarantees the return of a taxpayer's investment generally is treated as debt for tax purposes, and one that puts an investor's investment fully at risk is not. A structured note that is not by its terms fully principal-protected may, however, have terms that make it likely that an investor will be paid amounts that equal or exceed its investment, and the determination of whether those instruments should be treated as debt or a derivative for tax purposes is more difficult.

Under Treasury regulation section 1.446-3(g)(4), a swap with "significant periodic payments" is treated as two separate transactions—a swap and a loan—each of which must be accounted for separately. Although the regulations provide several examples to illustrate this rule, they do not define "significant periodic payments," creating uncertainty as to whether certain swaps contain deemed loans for the purposes of this rule.

absence of a demonstrable improvement in the law, a radical change of this kind should not be made. Other members believe that the benefits of aligning taxpayers' taxable income from derivatives with their economic income, and abolishing a raft of arbitrary and (in the aggregate) irrational rules that effectively permit taxpayers to elect how they wish to be taxed on economically similar transactions, far outweigh the disadvantages of the proposed regime, and that the perfect should not be the enemy of the good. As these disagreements illustrate, whether a mark-to-market regime is preferable to current law in light of the marked advantages and disadvantages of such a regime described above is a very difficult determination. We do not believe that there is a clearly "right" choice.

On balance, we believe that a mark-to-market regime for derivatives could be a substantial improvement over current law, provided that (a) the regime is limited to actively traded derivatives and derivatives on actively traded underlying property or positions, and (b) workable rules are provided for mixed straddle transactions in which a non-derivative is hedged by or hedges one or more derivatives. We provide below detailed comments on these and other issues that we believe should be addressed before any version of the proposals made by the Discussion Draft become law.

In particular, (i) we believe that the proposal in its current form would give rise to a high degree of complexity and unintended consequences, unless either all readily valued positions (including securities and derivatives) are mandatorily marked to market, or adequate rules are provided for hedges of capital assets, (ii) we believe that the gain-acceleration rules for positions that become part of a mixed straddle effectively turn that part of the proposal into a "super -1259" anti-abuse proposal,[50] and that there are significant policy and technical issues with expanding section 1259 in this manner; and (iii) we believe that the proposal will affect "Main Street" taxpayers in unexpected ways, including for example eliminating the availability of the reduced tax rate for long-term capital gain under certain circumstances, not just "Wall Street" taxpayers. We discuss these concerns in more detail below.

2. *Proposed Investor Mark-to-Market Election*

Because we believe that mark-to-market rules can have the positive attributes identified above when applied to all of a taxpayer's positions that can be readily valued and converted to cash, we recommend that taxpayers be permitted voluntarily to mark their derivatives, securities and commodities positions to market without limitation, as long as they identify the scope of those positions in advance and cannot cherry-pick among related assets or liabilities. More specifically, we recommend that section 475's elective mark-to-market regime for traders in securities and commodities be made available to taxpayers that are investors as well as traders, subject to the restrictions set forth below.[51]

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[50] If an appreciated financial asset of a specified kind becomes part of a "constructive sale" transaction, which broadly means a transaction in which the taxpayer hedges away all or nearly all of its market risk to the asset, section 1259 marks the gain on the asset to market.

[51] Under current law, in our experience, the Internal Revenue Service challenges taxpayers that it believes do not have sufficient trading activity to qualify for the mark-to-market election for securities traders, regardless of whether income would be more clearly reflected if the election were permitted and regardless of whether the particular taxpayer can demonstrate that no abuse will result from the election. In view of the benefits of mark-to-

We recognize that allowing investors to elect a mark-to-market regime may raise more compliance and cherry-picking concerns than similar elections for dealers and traders. The most effective way to address those concerns would be to require that an investor that elects to mark its positions to market must do so for all of its investment securities, commodities and derivatives positions. Consideration would then need to be given to the question of whether the mark-to-market regime would also apply to investment vehicles wholly-owned, or perhaps controlled by, such taxpayers.

Current law permits dealers and traders to decide whether to mark to market some or all of their investment positions, however, so that an all-or-nothing rule for investors would be harsher than the rules applicable to dealers and traders. For example, a trader may elect to mark positions to market for one trade or business but not for another.[52]

Any investor election to mark assets to market should be crafted in a way that limits potential for abuse. Abuse may be most likely to arise from not including assets that should be marked within the portfolio that is subject to the election. Under current law, for example, traders are required to mark to market all securities "held in connection with" a trade or business for which they elect mark-to-market treatment, in order to limit their ability to cherry-pick.

We consequently recommend the following in order to prevent cherry-picking. Investors should be required to identify an account, or accounts, in which all positions will be marked to market; positions in the account should be required to be actively traded or otherwise readily valued without the need for an appraisal or the like; taxpayers should be required to include any related positions – for example, a hedge of a position in the account – in the account, subject to adverse consequences if they do not; taxpayers should be required to mark-to-market all identical positions held outside such an account (*i.e.,* all IBM stock held by the taxpayer), unless either the mark-to-market account or the investment account is managed by a third party with full discretion over the account that is not coordinating its investment management activities with the taxpayer's other positions; either taxpayers should not be permitted to transfer positions into a mark-to-market account, or, if transfers are permitted, losses on transferred-in securities should remain capital in nature; and gain on assets transferred out of such an account (or disposed of in the account and reacquired outside the account shortly thereafter) should

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market to the government as well as taxpayers, we believe that the statutory basis for devoting resources to this policing of the rules should be eliminated.

Expansion of the voluntary mark-to-market rules should be accompanied by an expanded set of rules for identifying positions as not subject to mark-to-market. For example, if a mark-to-market taxpayer merges into a non-mark-to-market taxpayer, the positions held by the latter should be deemed identified as not subject to mark-to-market unless the taxpayer affirmatively identifies them as subject to mark-to-market on a going-forward basis.

[52] Section 475(f)(A)(i) (a person engaged in a trade or business as a securities trader may elect mark-to-market treatment for securities held in connection with such trade or business). This language, and in particular the use of the word "such," implies that the same taxpayer may hold securities in connection with one trade or business for which mark-to-market is elected (for example, an equities business) and other securities in connection with a different trade or business for which mark-to-market is not elected (for example, a fixed income business). We understand, however, that the Internal Revenue Service may consider the election to be an "all-or-nothing" election sweeping in all securities trades or business. It would be useful for legislative history to clarify Congressional intent in this regard.

remain ordinary in nature.[53] We also recommend that Treasury be given power to limit the election to prevent abuse, for example to prevent a special purpose vehicle from being used as an accommodation party to cleanse an investment position of unfavorable tax attributes without the ultimate U.S. taxpayer being subject to mark-to-market ordinary treatment.

A substantial minority of the Executive Committee is concerned that the ability to select mark-to-market for one asset class (for example, stock) but not another (for example, swaps), or to select mark-to-market for some assets within a class but not others (for example, IBM stock but not Microsoft stock), could give rise to a form of gaming the system. They question whether as a policy matter it makes sense to permit taxpayers to make an election with respect to stock, for example, while the taxpayer continues to benefit from anomalies in the taxation of derivatives. These members of the Executive Committee would not propose an investor election to mark assets to market.

Other members of the Executive Committee either do not share these concerns, or believe that they can be addressed. One possible approach to addressing them would be to permit an election only in limited cases. For example, a possible approach to addressing electivity within an asset class would be to limit an investor election to an entire class of assets (for example, all stock held by the taxpayer). The broader concern could be addressed by limiting an investor mark-to-market election to fact patterns that would otherwise give rise to a straddle, since offsetting positions is the fact pattern where the election is most useful and most consistent with the history of existing mark-to-market regimes.

A majority of the Executive Committee does not believe that a limitation of that kind is necessary. They are of the view that since mark-to-market should clearly reflect income even if there are no offsetting positions, and dealers and traders are not subject to requirements of this kind, limiting an investor mark-to-market election in these ways is not necessary or appropriate. In practice, because electing to mark positions to market means that a taxpayer loses the potential for long-term capital gain, those members anticipate that the taxpayers most likely to make the election are those with offsetting positions that would today be subject to the straddle rules. Because the straddle rules are anti-abuse rules that frequently give rise to non-economic results, taxpayers that make the election are likely overall to be taxed on a more favorable basis than under current law. As taxpayers cannot predict at the time they make the mark-to-market election whether they will have net gains or losses, on balance the result should be appropriate as a tax policy matter. Regardless of whether that prediction is accurate, however, those members believe that the benefits of elective mark-to-market should be made more widely available.

B. The Scope of the Discussion Draft's Mark-to-Market Proposal; Character

The scope of the Discussion Draft's derivatives proposals, and the character of any gain or loss, are critical aspects. We first discuss in this Part III.B issues relating to (i) active trading, (ii) the list of assets or risks that a derivative may refer to, (iii) transactions not typically considered to be financial instruments, and (iv) some special types of financial transactions. By

[53] *Cf.* Section 1236 (rules applying similar concepts to dealers in securities that have investment accounts).

way of introduction to these issues, we list here transactions that might be within the scope of the proposal in its current form, assuming a very broad reading of the definition of derivative:

- Merger & acquisition stock purchase agreements
- Restricted stock units and unvested restricted stock
- Joint venture or other partnership buy-out options, and possibly operating partnership units in UPREITs
- Swaps, options, forward contracts, futures contracts, short sales, other typical derivatives, both exchange-traded and over-the-counter
- Structured notes, and conceivably a wide array of other debt instruments with conventional features like an early redemption right, as well as possibly debt instruments with a conversion feature[54]

The definition refers to "any contract…the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to" property including beneficial interests in partnerships or trusts. This definition is an improvement over the definition in the original Discussion Draft, which used a phrase – "evidence of an interest in" – that raised questions as to whether mortgage pass-through securities, trust preferred securities, tender option bonds, investments in commodity funds and other interests in funds organized in pass-through form, were within the scope of the mark-to-market regime as a result of the fact that interests in partnerships and trusts could be viewed as evidences of interest in the underlying assets held by those vehicles. We suggest that it be clarified that a partnership or trust is outside the scope of the definition of derivative even if the partnership or trust arises as a result of a contract between the parties rather than pursuant to a partnership or trust statute. Depositary receipt arrangements like the American depositary receipts specifically referred to by the Discussion Draft also should be excluded.

We note, however, that the definition does not address the potential use of partnership interests to replicate derivatives. For example, it is possible to allocate the returns from a partnership's investment in securities in such a manner that one partner is in the same economic position as if it had bought a call option on those securities and the other partner is in the same economic position as if it owned the securities and had written the call option.[55] We recommend that authority be granted to the IRS and Treasury to treat partnership interests or other instruments or arrangements that are close surrogates for derivatives as derivatives where necessary to prevent abuse.

[54] The intended application of the Discussion Draft proposal with respect to debt with embedded contingencies is not entirely clear. See Part III.D, below.

[55] See Treasury regulation section 301.7701-4(c)(2), Example 3. *Cf.* Robert Scarborough, *Partnerships as an Alternative to Secured Loans*, 58 TAX LAW REV. 509 (2005) (discussing the use of partnership interests to allocate economic returns from an underlying portfolio to a synthetic debt-like security and to a residual interest). While the article addresses partnership interests that function like synthetic debt instruments, a similar approach could be used to create synthetic derivatives.

1. *Actively Traded Limitation; Valuation Issues.*

For both valuation and liquidity reasons, a mark-to-market regime is easiest to justify and to administer for actively traded derivatives on actively traded property, such as futures contracts on various commodities. The Discussion Draft has much broader application. It defines the term "derivative" to include both non-actively traded derivatives on actively traded property and derivatives on non-actively traded property. By contrast, the Administration proposal applies to the former but not to the latter. We believe that the Administration proposal is a better approach.

Active trading

The advantages of the Administration's proposal include:

- It eliminates many types of transactions that are not traditionally considered financial instruments and that we believe were not intended to be covered, such as merger & acquisition transactions involving the stock of closely-held companies; joint venture arrangements and other contractual arrangements with respect to closely-held or illiquid partnership interests; and most real estate transactions.

- It eliminates potentially intractable valuation issues. In both the estate tax and transfer pricing areas, valuation is a fertile source of dispute and the government has frequently not prevailed when those disputes are litigated.[56] Congress has previously recognized that there are sound policy reasons for marking only regularly traded or "marketable" stock to market, in the rules for passive foreign investment companies.[57] The valuation of illiquid assets also has given rise to significant political and economic concerns in other contexts, notably concerns expressed by the Securities & Exchange Commission and by members of Congress with respect to "Level 3" securities (securities for which there are no observable market valuation inputs) during the financial crisis.[58] The fact that

[56] Proposed Section 485(e)(2), which provides that fair market value is to be determined without regard to any premium or discount attributable to the size of a taxpayer's holding vs. the total outstanding number of "trading units," would alleviate this concern, but only to a limited extent. That is because the rule works best if there are readily-valued units held by other taxpayers available as a basis to determine value. That will not be true for many of the derivatives, or even the underlying assets, within the scope of proposed section 486's definition of "derivative."

[57] Section 1296 provides an election to mark to market PFIC stock that qualifies as "marketable." For this purpose, marketable stock is defined as stock regularly traded on an exchange, or to the extent provided in regulations, a foreign corporation that is comparable to a RIC (*e.g.*, a mutual fund) or an option on PFIC stock. The Discussion Draft would require an option on PFIC stock to be marked to market, without regard to these constraints.

[58] Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards No. 157, Fair Value Measurements ("FAS No. 157") classifies assets as Level 1 assets (assets with quoted prices in active markets), Level 2 assets (assets for which there are quoted prices of similar instruments in active markets, quoted prices for identical or similar instruments in inactive markets, and observable market information on valuation parameters or market-corroborated information) and Level 3 assets (other assets). During the financial crises, there were widely divergent views about the proper way to value Level 3 assets, in particular mortgage-backed securities held by banks and other financial institutions. These concerns resulted in a March 2009 House subcommittee hearing in which some members of Congress urged FASB to reconsider its then-current rules and threatened Congressional action if FASB did not do so. The background to these issues is described in an SEC report issued in

concerns about the valuation of illiquid assets were significant enough to give rise to potential Congressional action illustrates the difficulty of the enterprise.

- We believe that limiting a mark-to-market regime to derivatives on actively traded property is unlikely to exclude any transactions that "should" be marked to market, provided that the term "actively traded" can be adequately defined.

- It may reduce concerns about fairness and liquidity.

The principal disadvantage of the Administration's proposal is that the term "actively traded" must be defined, and that the line-drawing exercise will necessarily be imperfect since levels of trading activity fall on a continuum.

- The tax law has limited experience so far with "actively traded" or similar definitions, notably in the straddle rules, the installment sale rules, other "regularly traded on an established securities market" rules, the new "publicly traded" rules for debt instruments, and the publicly traded partnership rules.[59] We recommend that a broad approach be taken.[60]

- In order to provide as much certainty as possible, we also recommend that a number of bright-line rules be provided. For example, all of the following could be deemed to be actively traded: any instrument that is traded on an exchange or the equivalent, or cleared through a central clearinghouse; any financial instrument entered into with a "dealer in securities" (within the meaning of section 475) or an affiliate or special purpose vehicle sponsored or managed by a dealer; and possibly any financial instrument that the taxpayer marks to market for GAAP or regulatory purposes. Conversely, property that is treated as non-actively traded property could include intercompany debt or equity; interests in

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December 2008. See United States Securities and Exchange Commission, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting*, available at http://www.sec.gov/news/studies/2008/marktomarket123008.pdf; see also Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Committee on Financial Services, *Mark-to-Market Accounting: Practices and Implications* (111th Cong. 1st Sess., Committee Print Serial No. 111-12, March 12, 2009), available at http://www.gpo.gov/fdsys/pkg/CHRG-111hhrg48865/pdf/CHRG-111hhrg48865.pdf.

59 *See, e.g.,* Section 1092(d) and Treasury regulation section 1.1092(d)(1) ("actively traded" under the straddle rules); Treasury regulation section 1.1273-2(f) (revised "publicly traded" rules for debt instruments); section 7704(b) and Treasury regulation section 1.7704-1 ("publicly traded" under the publicly traded partnership rules); section 453(f)(5) and Treasury regulation section 15a.453-1(e)(4)(iii) (under the installment sale rules, "an obligation shall be treated as readily tradable if it is regularly quoted by brokers or dealers making a market in such obligation or is part of an issue a portion of which is in fact traded in an established securities market."). For a list of more than a dozen provisions of the Code and regulations using the term "regularly traded" and variations thereof, see New York State Bar Association Tax Section, Report on Dividends Provisions of the Jobs and Growth Tax Relief Reconciliation Act of 2003, Report No. 1036 (Sept. 4, 2003), note 27, available online at http://old.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1036Report.pdf (last accessed on March 13, 2014).

60 The Administration proposal would treat a contract as a derivative if its value is determined "directly or indirectly, in whole or in part" by reference to the value of actively traded property. This definition is overbroad, in our view. It would, for example, allow taxpayers to elect into mark-to-market treatment by adding a peppercorn of value attributable to actively traded property. It also could result in marking to market interests in an entity that primarily holds non-traded assets such as real estate but that holds a *de minimis* amount of actively traded property.

entities with fewer than a specified number of investors; and possibly unique property other than debt, equity, or an instrument treated as a security for securities law purposes. Legislation also should make clear whether interests in an investment fund like a hedge fund that can be cashed out on a periodic (often quarterly) basis at fair market value should be treated as actively traded.[61]

- Another "disadvantage" that some proponents of a broad definition have noted is that limiting the mark-to-market regime to derivatives on actively traded property does not address all of the concerns described in the first set of bullet points under this heading. For example, there may still be valuation issues with an illiquid option on actively traded property. We acknowledge that such concerns will still exist, but in our view they are easier to address than in the case of a comparable option on non-traded property. Moreover, the fact that limiting "derivatives" to contracts on actively traded property solves only some problems and not all of them does not seem to us a reason not to do so.

- A more policy-based concern is that mark-to-market is intended to reflect accretions to, or reductions in, wealth, and that such changes do not depend on whether an asset is actively traded or can be readily valued. Drawing a line between derivatives on actively traded underlying assets and other derivatives thus does not reflect any fundamental policy difference between them. In the absence of such a difference, therefore, mark-to-market should apply to all derivatives.

  We acknowledge that there are no fundamental differences between derivatives on actively traded assets and other derivatives. However, our tax system is not based solely on theoretical policy considerations. As we have already observed, for example, as a policy matter it is equally appropriate to apply a mark-to-market regime to IBM stock as it is to derivatives on IBM stock. Assuming that any mark-to-market legislation as enacted excludes contracts to purchase a home and other conventional real estate purchase contracts, bets on the performance of sports teams, merger & acquisition contracts, stock-linked employee compensation, and stocks and bonds that are actively traded and readily valued, the legislation will reflect multiple considerations other than pure tax policy. We believe that the fairness, complexity, uncertainty and administrability issues we have raised above all powerfully support limiting any mark-to-market regime for derivatives to derivatives on actively traded property.

Valuation

Even if the definition of "derivative" is narrowed as we recommend, we believe that any legislation mandating mark-to-market treatment should provide more guidance on what valuations are treated as authoritative. This is particularly necessary for instruments that do not trade on a regular basis, for example structured notes that are not exchange-traded or any

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61 Investment funds may hold primarily liquid, readily valued assets, or primarily illiquid assets like all of the stock of a portfolio company, or a mixture of types of assets. A "one size fits all" approach therefore is not likely to be appropriate.

derivatives embedded in another instrument. However, valuation differences can arise for many reasons:

Bid vs. ask vs. mid-market. A securities dealer typically will quote one price at which it is willing to buy a bond ("bid" price) and another, higher, price at which it is willing to sell the bond ("ask" price). Financial contracts such as options, swaps, forward contracts and structured notes that are not traded on an exchange or cleared through a central counterparty also have bid and ask pricing. The bid/ask spread (that is, the difference between the bid price and the ask price) can be large, for example for structured notes, because many such instruments typically do not trade at all unless they are listed on an exchange.

The price that is midway between the bid and ask is the "mid-market" price. Derivatives dealers typically mark financial contracts such as options, swaps and forward contracts that are not traded on an exchange or cleared through a central counterparty to mid-market on their books, with various adjustments.[62]

Bid, ask and mid-market are all "real" valuations for a single position. Congress should either make clear that a taxpayer may choose to use any of these valuations, provided that it does so on a consistent basis, or specify which one should be used. Using mid-market pricing may be more neutral, and may be closer to the starting point for valuations that dealers use on their books. However, by definition it will never be the price at which a customer could close out its position.

Different taxpayers, different valuations. The truism that an asset may have different values to different taxpayers is also applicable to derivatives. That is the case not only because different parties are on different sides of the market (buyers vs. sellers; or dealers vs. customers), but because different parties on the same side of the market may value the same asset differently. For example, two dealers or two customers may value the same derivative differently. A dealer also may not value the position as a whole, but instead break it into component parts that it values. Different dealers may take different approaches to this.

Tax vs. financial accounting. In our experience, taxpayers that mark positions to market for tax purposes typically follow, or prefer to follow, the marks for those positions on their financial books. This is true for several reasons: the tax department does not have better access to valuation information than those charged with valuing the assets for other purposes; following books avoids the need to track tax/book non-conformity and report it to the IRS; and it is more efficient to follow financial accounting books than to build a separate tax valuation system. Moreover, since it is more common for overvaluation errors to go uncorrected for extended periods of time than for undervaluation errors to do so, because high values are preferable for most non-tax purposes, following book valuations tends to limit reported losses and increase reported gains, which is conservative from a tax perspective.

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[62] Treasury regulation section 1.475(a)-4 provides a safe harbor for derivatives dealers that envisages use of mid-market valuations. In our experience, the safe harbor is not widely used because it diverges from market practice in some important ways. Instead, market participants typically follow the guidance in Industry Director Directive "I.R.C. § 475: Field Directive related to Mark-to-Market Valuation" (LB&I Control No. LB&I-4-1110-033, April 14, 2011), available online at http://www.irs.gov/Businesses/I.R.C.-475-Field-Directive-related-to-Mark-to-Market-Valuation (last accessed on March 13, 2014).

The Discussion Draft does not include a provision contained in a prior draft of proposed section 485(e), which recognized the benefits of following financial accounting valuations and provided that fair market value shall be determined under the method used for preparing reports to shareholders and other third parties with a vested interest in those numbers. We think providing less guidance in respect of valuation issues is a step backwards, and the Discussion Draft should reinstate the prior provision. That said, however, there were two limitations on the prior provision that we found to be problematic. One is that it applied only "where there is no readily ascertainable fair market value." The other was that it applied only to the extent provided in regulations. We recommend that the first limitation be dropped and that the second be revised so that taxpayers must follow their book valuation except to the extent provided in regulations. This recommendation is based on the history of section 475. Congress expressed its expectation in the legislative history of section 475 that taxpayers should be permitted to follow their books.[63] Notwithstanding that, the IRS has resisted allowing taxpayers to do so.[64] In our view, therefore, Congress should mandate book/tax conformity, except to the extent that the IRS and Treasury identify specific circumstances where such conformity is not appropriate.

For taxpayers that do not mark positions to market for other purposes, such as individuals, legislation should provide a means for them to obtain valuations, provided that they use a consistent approach to all valuations.[65] If a derivative is not exchange-traded or cleared through a central clearing organization that marks positions to market daily, the most natural person to supply a valuation is another party to the same transaction that is marking the position to market for its own purposes. Such parties might include a derivatives dealer or a professional asset manager, such as a hedge fund manager in the case of investors in a hedge fund. As discussed above, any taxpayer's mark may vary from a theoretically pure valuation for various reasons, so that the standard for supplying any such information should be based on reasonableness. Dealers may have competitive concerns about supplying such information, and cost concerns about being subject to a new information reporting mandate. Congress would need to make a judgment about how to balance such concerns with the need for individuals and others to obtain valuation information.

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[63] H.R. Rep. 103-11, reprinted in 1993-3 C.B. 237 ("Inventories of securities generally are easily valued at year end, and, in fact, are currently valued at market by securities dealers in determining their income for financial statement purposes"); Department of the Treasury, *General Explanation of the President's Budget Proposals Affecting Receipts* 89-90 (Jan. 30, 1992); Department of the Treasury, *General Explanation of the President's Budget Proposals Affecting Receipts* 36 (Feb. 25, 1993).

[64] This history of the section 475 safe harbor referred to in note 62 above illustrates the need for the approach recommended in the text. In the late 1990s, dealers in securities subject to section 475 requested guidance from the IRS on valuing derivatives in order to avoid valuation disputes with the IRS. The IRS published final regulations providing a safe harbor for derivatives valuation in 2007. However, the regulations impose conditions upon the use of the safe harbor that do not comport with the valuations permitted by generally accepted accounting principles and actually used by taxpayers. Our understanding is that the IRS adopted this approach because it did not trust the financial accounting valuations used by taxpayers. Indeed, perhaps it was the IRS's distrust of those very valuations that led the IRS to attempt to develop its own mark-to-market tools with the assistance of scientists from a lab in Los Alamos, New Mexico. Those efforts were abandoned because of cost overruns and administrability issues. *See* Lee A. Sheppard, *The Bank One Case: Marketing to no Market*, 91 TAX NOTES 28 (April 2, 2001).

[65] We understand that the Dodd-Frank Wall Street Reform and Consumer Protection Act requires dealers to provide mark to-market valuations to customers for some customers, but that those requirements do not apply to all of the transactions that would be subject to the Discussion Draft's mark-to-market regime.

2. *Non-Financial Instruments*.

The Discussion Draft in its current form would apply to merger & acquisition transactions, joint ventures, certain employee compensation that is linked to equities, non-business/investment contracts entered into by individuals as part of their personal lives and real estate transactions involving multiple pieces of property. While we believe that most or all of these were not intended, the draft would need to be revised to make that clear. In the case of transactions that are already subject to long-standing and quasi-independent bodies of tax law, like compensation, we believe additional consideration would need to be given to whether those systems are "broken" before imposing mark-to-market rules. In particular, since the Discussion Draft would not apply to compensatory options, we recommend that the definition of a derivative be revised to exclude other forms of equity-linked compensation (such as restricted stock units). In the case of "consumer" transactions like mortgage rate-lock agreements and contracts to purchase home heating oil to heat an individual's residence, we suggest that transactions by individuals of a kind such that any expenses or losses therefrom would not be deductible under section 212 be carved out of the scope of the mark-to-market regime. We recommend that Treasury be given authority to carve out other types of transactions that are identified post-enactment as subject to the rules without any indication that Congress intended that result.

In the case of real estate, the Discussion Draft provides authority to the IRS and Treasury to modify the proposed statutory provision for derivatives involving multiple pieces of property. Since many commercial real estate transactions involve multiple pieces of real estate or other types of real property, such as leases, this would be a very substantial undertaking. We are aware of only one type of contract relating to real estate that would seem to be a natural candidate for mark-to-market, which is a derivative on a benchmark real estate index, such as the Standard & Poor's Case-Shiller Home Price Indices. We recommend that Treasury be given authority to include contracts on benchmark indices within the scope of a derivatives mark-to-market regime, rather than including contracts on multiple real estate properties in the first instance and then granting authority to carve them out.

3. *Securities Loans; Brokerage Accounts; Repos; Wash Sales* .

The Discussion Draft provides that, to the extent provided by the Secretary, a derivative does not include the right to the return of securities pursuant to a securities lending, sale-and-repurchase transactions ("repos") and similar financing transactions. The phrasing of this provision in the Discussion Draft leaves open the possibility that such transactions would be treated as derivatives pending the promulgation of regulations, which might not occur for several years following the enactment of the relevant legislation. As set out below, we think there are strong reasons to exclude securities loans, repos, and the right to delivery of "rehypothecated" securities from the definition of a derivative. Because the Discussion Draft already contemplates such exclusions, we would recommend that the rule in proposed section 486(b)(3) be modified to exclude the right to the return of securities under securities loans, repos, and similar transactions without the need for regulations. Treasury could retain the authority to subject certain securities loans, repos and other transactions to derivative treatment in appropriate situations.

Securities loans

A securities loan is a transaction in which an owner of stock or debt securities "lends" those securities to another person, usually a securities dealer, in exchange for a contractual promise by that person to "return" the securities to the original owner.[66] Put differently, a securities loan can be viewed as a current transfer of securities + a forward contract to retransfer those securities. A securities loan therefore might be treated as a derivative either because of its forward contract element or because it is characterized as a "similar financial instrument."

Typical lenders of securities include large institutional investors in securities, such as pension plans, endowments, mutual funds and insurance companies. These investors often have a long-term strategy for holding the securities, and lend them out because by doing so they can increase their return by earning fee income or paying a below-market rate of interest on cash collateral that they receive when they lend out their securities. Congress has recognized in the past that the lending of securities has benefits both for the securities lenders and for the securities markets.[67] Under current law, neither the loan of the security nor its return is treated as a recognition event, provided that certain conditions are satisfied that are intended to ensure that the securities lender remains in the same economic position with respect to the security during the term of the loan as it was before the loan.[68] Requiring taxpayers that lend out their securities to mark their securities loan positions to market would dramatically change that result, and conceivably (we have no information on this) could discourage mutual funds and insurance companies from lending out their securities.

For the reasons described above, we agree that it is preferable not to treat long-term investors who temporarily lend out their securities as subject to mark-to-market treatment. A dealer that enters into securities loans as part of the ordinary course of its dealer business should continue to be required to mark them to market, as under current law. We therefore agree with the approach taken by the Discussion Draft, except that we do not see any reason why the exclusion of securities loans from the definition of "derivative" should be dependent on the issuance of regulations. Instead, securities loans should be excluded except to the extent

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[66] Section 1058 is the general statutory provision addressing securities loans. It characterizes them in the manner set forth in the text. However, a transaction may be a "securities loan" in the ordinary meaning of that term even if it does not comply with section 1058.

[67] *See* S. Rep. No. 95-762, 95th Cong. 2d Sess. 5 (1978), for example, noting time delays that brokers may face in obtaining securities to deliver to a purchase and concluding that "[i]t is generally thought to be desirable to encourage organizations and individuals with securities holdings to make the securities available for such loans since the greater the volume of securities available for loan the less frequently will brokers fail to deliver a security to a purchase within the time required by the relevant market rules."

[68] While not directly related to the Discussion Draft, we note that a recent 9th Circuit opinion has been understood by many taxpayers, and it appears by the IRS, as treating a securities loan for a relatively short fixed term as giving rise to a taxable disposition of the loaned securities. *Samueli v. Commissioner*, 661 F.3d 399 (9th Cir. 2011). This ruling facilitates what is essentially an elective mark-to-market rule for loanable securities, which can be used to accelerate built-in gain in order to refresh expiring capital losses. Congress may wish to consider whether this is a desirable, or intended, application of section 1058. We believe it is not. *See* New York State Bar Association Tax Section, *Report on Certain Aspects of the Taxation of Securities Loans and the Operation of Section 1058* (Report No. 1239, June 9, 2011), *available at* http://old.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1239Rpt.pdf (last accessed on March 13, 2014).

provided by regulations, so that Treasury has the power to require that securities loans be marked to market in the case of abuse.

Repos

We also support the exclusion of repos from the definition of the term "derivative," again on an automatic basis. A repo takes the legal form of a sale of a security, usually a Treasury or other debt security, to a buyer who contemporaneously promises to resell it to the original owner. A traditional repo, in which the buyer holds the security during the term of the repo, is treated as a secured loan for U.S. federal income tax purposes. For several decades, however, it has been common for the buyer in a repo to retransfer the securities (a "repo with rehypothecation").[69] If such transactions were treated as derivatives, trillions of dollars of transactions would be affected, and the market for Treasuries conceivably (again, we have no information on this) could be disturbed, as repos are conventional financing transactions for Treasuries.

Brokerage accounts

Marking securities loans or repos by non-dealers to market would also have two other important consequences. The first is that it would very likely result in marking to market stock and other securities positions held by individuals and other retail customers in brokerage accounts. That is because brokers are permitted by the U.S. securities laws to borrow customer securities, subject to various constraints, and they do so regularly in order to finance the margin credit extended to those customers.[70] Customers consent to these borrowings, or "rehypothecations" as they are typically referred to, when they sign a brokerage account agreement, and thereafter typically the broker does not provide notice on a real-time basis or request consent when it borrows securities from a customer's account. Consequently, if rehypothecation from a customer's account were treated as a derivative for purposes of the Discussion Draft's mark-to-market rules, customers would find themselves unknowingly thrown into those rules if they wished to buy securities on margin. We believe that the exclusion of securities loans and repos from the scope of the term "derivative" addresses these transactions. However, this fact pattern emphasizes the need for the exclusion for securities loans and repos to be automatic, rather than dependent on Treasury regulations.

Wash sales

Wash sales raise additional issues. If a taxpayer sells stock at a loss, and enters into an option or contract to acquire the same stock within a 30-day period around the stock sale date, the loss is deferred under current law.

[69] *See, e.g.,* Private Letter Ruling 200207003 (discussing issues relating to a "matched book" repo operation in which the taxpayer buys (reverses in) securities in some repos and sells (repos out) the same securities in other repos.

[70] Congress recognized this practice in section 6045(d), which requires brokers that rehypothecate securities owned by customers to report income with respect to those securities as "substitute" dividends or interest in specified circumstances.

The Discussion Draft provides that the wash sale rules do not apply to mark-to-market losses from a section 486 "derivative."[71] That rule makes sense, as the wash sale rules generally should not apply to a mark-to-market loss on a derivative since the mark-to-market rules generally remove the ability to choose the timing of a loss. However, as drafted the Discussion Draft does not coordinate properly with the wash sale rules in a fact pattern like the one described above if the option or contract is still open at year-end. That is because (a) the loss deferral rule of section 1091(a) applies if the taxpayer enters into an option or contract to acquire the stock and (b) such an option or contract is a section 486 derivative. Consequently, the loss on the stock would be deferred under the wash sale rules, and section 485 would require the option or contract to be marked to market at year-end, so that the taxpayer may be able to take the loss – as an ordinary loss – at that point.[72] The wash sale coordination rule should be revised so that the loss on the sale of the stock is not taken into account in determining the gain or loss on the derivative, and is suspended until the taxpayer finally terminates the derivative or an economic equivalent thereof.

4. *Character of Mark-to-Market Gain or Loss*.

The Discussion Draft provides that gain or loss is treated as ordinary, and that derivatives within its scope are not treated as capital assets. We note here some considerations relating to the first point, and recommend that the second be reversed or limited.

To the extent that derivatives otherwise would be capital assets, the treatment of gain or loss as ordinary has a number of noteworthy features. The report has already noted that mismatches in character between gain and loss on an underlying asset and a derivative on that asset may produce either abusive transactions or whipsaw. There are also a number of more technical observations.

One is that limitations on the deductibility of capital losses do not apply, which is generally appropriate in light of the fact that taxpayers cannot choose the timing of the loss. We comment elsewhere in this report on circumstances where taxpayers may in fact have some electivity. The Discussion Draft also provides that any ordinary loss is treated as attributable to a trade or business for purposes of section 172(d)(4), so that it can be carried back and forward under the rules for net operating losses.

It would be possible, however, to adopt a similar rule for carrybacks and carryforwards of capital losses attributable to derivatives if desired, as is the case under current law for losses arising from section 1256 contracts. Treating losses from derivatives, and from mixed straddle positions, as ordinary in character permits losses on what are conceptually capital assets to reduce tax on ordinary business income. This may be the better choice, in view of the

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[71] *See* Section 3401(f)(5) of the Discussion Draft.

[72] This analysis assumes that the loss on the stock is carried into the contract or option to acquire new stock. It is not entirely clear that that would happen, although that would be consistent with the intended operation of the wash sale rule as a loss deferral rule, rather than a loss disallowance rule. The statutory language of section 1091(d), which provides basis adjustment rules for replacement property, appears to be drafted under the assumption that the taxpayer will always reacquire replacement stock. That does not always happen. For example, an option may lapse. In the normal case, where a taxpayer sells stock and enters into a contract to acquire new stock, or an at-the-money option to acquire new stock, the taxpayer should be permitted to adjust the basis of the contract or option so that it can benefit from the deferred loss if it terminates the contract or option or the option lapses.

fact that taxpayers cannot defer the recognition of losses on derivatives under a mark-to-market system, but it may have unforeseen consequences.

On the gain side, one significant consequence of ordinary income treatment is that the preferential rates for long-term capital gains do not apply. One may view that as appropriate, because a taxpayer that takes exposure through a derivative is not investing in the type of assets for which the preferential rate was ordinarily intended. It is certainly appropriate, in our view, to repeal the "60/40" rules of section 1256, which provide long-term capital gain treatment, in part, to short-term positions. However, one may ask whether gains on derivatives are less worthy of preferential rates than other assets, like collectibles.

If mark-to-market derivative gain or loss were treated as capital rather than ordinary, there would be technical issues as to how to apply the Code's holding period rules to financial instruments that are subject to mark-to-market timing rules. For example, it would be possible to treat gain or loss arising in the first year of ownership as short-term gain or loss, and subsequent gain or loss as long-term. However, that approach has a number of deficiencies. For example, the end of the first year of ownership is likely to be in the middle of a taxable year, so that either the taxpayer must effectively mark the asset to market at that point or the holding period rules would have to be modified so that they require a taxpayer to hold the position through the end of a taxable year. The potential for short-term gain/long-term loss or short-term loss/long-term gain also raises concerns similar to, although not as troubling as, the capital gain/ordinary loss and capital loss/ordinary income issues discussed elsewhere in this report.

A final consideration is that ordinary income/loss treatment eliminates the need to reconcile the fact that mark-to-market gains and losses may be directly related to ordinary income or expense items. For example, if interest rates rise, an interest rate swap pursuant to which a taxpayer is entitled to receive fixed rate payments can be expected to lose value because the remaining payments on the swap are worth less on a present value basis. If a taxpayer were required to treat a mark-to-market loss on that swap as a capital loss, but to treat current swap payments as ordinary, a taxpayer with no offsetting capital gains might find itself required to pay tax on an amount greater than its actual increase in wealth, which would be contrary to the basis for requiring mark-to-market in the first place. Accordingly, on balance, we agree that ordinary treatment for mark-to-market gains and losses is appropriate. If a decision is made at a future point to treat gain or loss on derivatives as capital, we would be pleased to discuss the issues noted above with respect to a capital mark-to-market regime further.

We do have concerns, however, about the provision that treats derivatives as excluded from treatment as capital assets for all purposes of the Code. Nothing in sections 485 and 486, or the Technical Explanation of those sections, suggests that they were intended to affect other tax rules. There are, however, other tax rules that operate differently depending on whether an asset is considered a capital or ordinary asset. For example, non-U.S. taxpayers that are engaged in the conduct of a U.S. trade or business are subject to different rules for purposes of determining whether U.S. source income is effectively connected, depending on whether gains or losses are treated as gain or loss from the sale of capital or ordinary assets.[73]

Similarly, the rule referred to above that treats losses as attributable to a trade or business of the taxpayer could raise questions about whether a non-U.S. taxpayer subject to these rules, like a hedge fund, was deemed to be engaged in the conduct of a trade or business in the United States. Questions could also be asked as to whether a tax-exempt taxpayer had derivatives income from an "unrelated trade or business" in determining whether it is subject to unrelated business income tax, or whether for treaty purposes gain from derivatives earned by a non-U.S. treaty resident is attributable to a permanent establishment deriving from a trade or business in the United States. We do not think that any of these results would be correct, as the proposed statutory language applies only "for purposes of section 172(d)(4)," but it would be useful for legislative history to make clear that the trade or business characterization applies solely for purposes of section 172.

We do not think that it was intended that derivatives be treated in effect as assets held in the conduct of an active business for purposes other than timing and character, and consequently recommend that derivatives continue to be treated as capital assets notwithstanding that they give rise to ordinary income or loss.[74] We also recommend that consideration be given Code, for example in determining subpart F income or income of a passive foreign investment company ("PFIC"), and if so that specific rules be provided. For example, if a U.S. taxpayer acquires a foreign company that was not previously a controlled foreign corporation (a "CFC"), the U.S. taxpayer should not be required to determine that company's earnings and profits for U.S. tax purposes by treating derivatives held by that company in prior years as marked to market. We would be pleased to consider this issue further if that would be helpful.

C. Hedging Capital Assets

A natural consequence of marking derivatives to market but not the underlying asset is that rules must be provided for transactions that involve both types of positions. Such transactions may include a taxpayer that owns appreciated stock and that wishes to hedge against downside risk by buying a put option on the stock, or to generate additional income by writing covered call options on the stock; a taxpayer that owns a portfolio of debt securities and wishes to hedge some or all of the returns on the securities in order to better match its liabilities; possibly a taxpayer that owns foreign subsidiaries and hedges the currency risk of its foreign operations; and a taxpayer that buys a convertible bond and shorts the underlying stock in order to derive an arbitrage profit from the call option embedded in the convertible bond.

The Discussion Draft proposes that all positions in a mixed straddle of this kind should be subject to the Draft's mark-to-market regime. The Draft also would require that any built-in gain in the non-derivative position be accelerated and taken into account when the position becomes part of the mixed straddle, with limited exceptions. The holding period of any

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73 *See* Treasury regulation sections 1.864-4(b) (rules for income other than FDAP and capital gain/loss), 1.864-4(c) (rules for gain or loss from capital assets).

74 In addition, sections 64 and 65, which treat gains or losses from property that are treated as ordinary income or expense as gains or losses from the sale of property that is not a capital asset, should not apply.

straddle position would be suspended while it is part of the straddle. These rules do not apply to transactions properly identified as hedging transactions under sections 1221 or 988(d).[75]

More technically, positions would be subject to the mark-to-market regime if they constituted "offsetting positions," *i.e.* if there were a "substantial diminution in the taxpayer's risk of loss" from holding a given position by reason of holding one or more other positions. This is a modified definition of the term "straddle," as currently defined in section 1092(c). The modifications include (i) removing any requirement that the positions be with respect to actively traded personal property and (ii) repealing the exemption from the straddle rules for "qualified covered call" transactions (although see Part III.C.3 below for a discussion of the application of the built-in gain acceleration rules to "qualified covered call" transactions). The first of these modifications presumably is based on the fact that the Discussion Draft's mark-to-market proposal generally is not limited to positions in actively traded property, and we reiterate in this context the comments previously made on that approach.

The Administration proposal would take a more limited approach to straddles. It would require straddles consisting of actively traded stock and a hedge to be marked to market, with the same acceleration of built-in gain as provided for in the Discussion Draft. Other straddles would not be marked to market. Instead, regulatory authority is provided to match the timing, source and character of income, gain, deduction and loss from a capital asset and its hedge. This matching regime is not further described, but may be intended to be similar to the capital asset hedge matching rules described below. If so, an important additional consideration would be how such transactions would be treated before the issuance of regulatory guidance.

This Part III.C addresses (i) whether marking mixed straddle positions to market is the best approach, or whether instead a capital asset hedge matching rule of some kind should be devised, (ii) the scope of the Discussion Draft's mixed straddle proposal, and identification issues, (iii) the treatment of positions owned prior to entering into the straddle, (iv) the treatment of positions after they have been part of a mixed straddle, including a discussion of character issues for mixed straddle positions, and (v) a number of special issues.

1. *Marking Straddles to Market.*

Proposed section 485(c) technically applies to straddles consisting entirely of derivatives, but since those positions would be marked to market and give rise to ordinary gain/loss in any event, we discuss here "mixed" straddles, meaning a straddle that includes at

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[75] The Discussion Draft proposes a change to the hedge identification rules that treats a hedge as properly identified if it is treated as a hedging transaction for GAAP purposes on an audited financial statement relied on by third parties. This is a welcome and useful proposal. In view of the fact that there are a number of technical differences between GAAP and the corresponding tax rules, for example because GAAP disregards legal entities for the most part, we suggest that supplemental authority be granted to Treasury to prescribe how a GAAP hedge identification will be taken into account. We also suggest that authority be granted to treat identifications for other comparable purposes, for example regulatory purposes or the International Financial Reporting Standards used by non-U.S. taxpayers, in a similar manner, and that a similar rule apply for section 988(d) purposes.

While the Discussion Draft and Technical Explanation do not refer to Treasury regulation section 1.1275-6 integration transactions, we assume that the proposed mark-to-market rules are not intended to override that election. If that is true, it would be useful to clarify the point.

least one derivative subject to mark-to-market/ordinary treatment and at least one position that is not, on a stand-alone basis.

The most natural alternatives for rational taxation of a mixed straddle are either (i) to subject both positions to the mark-to-market/ordinary regime, or (ii) to treat both positions under conventional realization method of accounting rules. There is, however, at least one further alternative, which is to apply matching rules that modify the realization rules by limiting taxpayers' ability to manipulate timing and character. We assume that treating both positions under the conventional realization rules is undesirable, because that would result in the application of current law, with all of its complexities and inadequacies. Accordingly, we discuss the first and third alternatives.

Some advantages of the all-marked/ordinary alternative could be:

- Marking mixed straddles to market would clearly reflect income.

- Marking actively traded underlying assets and their hedges to market is consistent with the historical contexts in which mark-to-market has been mandated or permitted in the past, and eliminates in this context many of the trade-offs between the pros and cons of a derivatives mark-to-market regime identified earlier in the report.

- No new rules are required (or so the drafters of the Discussion Draft appear to assume); the same mark-to-market rules that apply to derivatives would apply to all straddle positions.

- All timing and character issues are eliminated. Consequently, the scope of current law's straddle (section 1092 and section 263(g)) and conversion transaction (section 1258) rules would be drastically narrowed, and possibly those provisions in their current form would cease to have any real-world effect.

As discussed below, however, we believe that several of those points are not true when the assets being marked are capital assets, particularly when the taxpayer holds those assets both before and after the straddle – that is, when it engages in only a temporary straddle. Some disadvantages of the all-marked/ordinary alternative could be:

- Taxpayers that are buy-and-hold investors who are ordinarily taxed under a realization method of accounting, like most individuals, could find themselves subject to the mark-to-market system for only part of their portfolio, for a limited period of time, if they engage in a temporary hedge. This adds complexity and invites error because it depends on the taxpayer's ability to move smoothly into and out of the mark-to-market system, and the current tax regime does not have a meaningful precedent for this.

- In the case of a taxpayer that engages in an asymmetric straddle – for example, a taxpayer that owns stock and buys a put option that protects against a fall in the value of the stock but does not affect its opportunity for gain on the stock – taxpayers may lose the benefit of long-term capital gain treatment for gains that are not offset by any derivative. Conversely, a taxpayer that owns stock and sells an out-of-the-money covered call option pursuant to which the taxpayer limits its potential gain on the stock will enjoy an ordinary loss if the stock drops in value, even though the call option does not affect the taxpayer's risk of loss and the taxpayer continues to hold the stock.

- A taxpayer that holds an asset that it expects will lose value in the near future – for example, a bond portfolio that will lose value when the Fed begins to "taper" its market interventions, and interest rates rise – can enter into a partially offsetting and temporary derivative position in the hope of transforming any losses into current, ordinary losses rather than deferred, capital losses.[76]

- As discussed below, for taxpayers that hedge only part of their non-derivative positions, there will be great need for precision in determining what part of those positions is treated as part of the straddle.

- As discussed in more detail below, the gain acceleration rule for pre-existing positions may give rise to results that in some cases appear punitive to taxpayers and in other cases may appear abusive to the government.

- As discussed in more detail below, we believe that there are significant character mismatch and other technical issues associated with holding a capital asset post-straddle that would need to be addressed. For example, in the case of a debt instrument that was part of a straddle, should loss deducted while the debt was part of a straddle create, or increase, the OID (or market discount) on the debt instrument?

As stated above, a possible alternative would be to create a new set of rules that retains the basic framework of current law's realization method of accounting, but that limits taxpayers' ability to accelerate the timing of tax losses not reflective of their economic position and to convert ordinary income into capital gain. One possibility would be a new capital asset hedging election modeled on the rules under sections 1221 and 446 for hedging transactions, which would permit taxpayers to elect to match the gain, income, loss and deduction on straddle positions.[77] Another possible approach would be to expand the current identified straddle rules

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[76] Compare, for example, the "identified mixed straddle" transactions that insurance companies engaged in in order to accelerate capital gains on their portfolios in order to utilize expiring capital losses. *See PwC Requests Delay in Effective Date of Temporary Regs on Straddles*, 45 THE INSURANCE TAX REVIEW 991 (Nov. 2013).

[77] A rule of this kind was recommended by one of the witnesses that testified in favor of a mark-to-market regime for derivatives. Statement of Andrea S. Kramer to the U.S. Senate Committee On Finance and the U.S. House Committee On Ways & Means, *Tax Reform and the Tax Treatment of Financial Products* (Dec. 6, 2011), available at http://www.finance.senate.gov/imo/media/doc/120611%20Kramer%20Testimony.pdf (last visited January 19, 2015). For additional discussion of a possible capital asset hedging regime, see Yaron Z. Reich, *The*

of section 1092(b). Because the straddle rules are anti-abuse rules, however, they are not ideally suited to be the foundation of rules that would apply to hedging transactions undertaken for legitimate business purposes, although some elements of the straddle rules might be incorporated into any new hedging regime.

We describe below some aspects of a possible capital asset hedging election, and its advantages and disadvantages. Important features of a capital asset hedging election could include the following:

- Like the section 1221 hedging transaction election, a capital asset hedging regime could be elective. The default rule could be either (i) mark-to-market/ordinary treatment for derivatives and current law for non-derivatives or (ii) the Discussion Draft's proposed mark-to-market/ordinary treatment for all positions in the straddle. The former would subject gains to current taxation but defer the taxation of losses, under the existing straddle rules. The latter raises the issues summarized above and discussed in more detail below. Since both of these possible default rules can give rise to adverse consequences to taxpayers, we expect that taxpayers will have an incentive to make a capital asset hedging election.

- Like the section 1221 hedging transaction election, taxpayers would be required to identify the positions subject to the election no later than the date on which positions become part of the straddle. The election should permit taxpayers to do so through means similar to those provided in the regulations under section 1221, for example by treating all positions in an identified account as subject to the election. Because taxpayers have more flexibility to time the recognition of gains and losses on capital assets as compared to ordinary property or obligations, however, it would be essential that any identification be contemporaneous and unambiguous.

- As under the current straddle rules, the deductibility of losses on positions within the scope of the election could be limited to the extent of offsetting gains on other positions in the straddle. This is different from the section 1221 hedging election, which operates on a "one-way" basis – it matches the timing and character of realized gains or losses from *hedges* to the timing and character of hedged items, but it does not affect the timing of income or loss from the *hedged items* themselves. Because taxpayers have flexibility to time losses on capital assets, we think the straddle approach is preferable here. The timing and character of gains or losses on hedges generally should offset realized losses or gains on hedged items and vice versa. Any excess gain or loss from one position could increase or decrease the basis of other positions in the straddle, possibly after carrying the excess back or forward for a period of time.

Case for a "Super-Matching" Rule," 65 TAX L. REV. 241 (2012); Michael Farber, *Some Observations on the Hedging Rules* (Tax Forum No. 651, Nov. 4, 2013).

- Similarly, there would need to be rules addressing the potential for conversion transactions, *i.e.*, transactions that convert ordinary income into capital gains, and transactions that combine ordinary expenses and economically related capital gains, as under current sections 1258 and 263(g). We believe that recharacterization rules of this kind should be simplified. For example, ordinary expenses related to a mixed straddle could be treated like losses and subject to the rules described in the prior paragraph.

- In the case of hedges of portfolios of capital assets that change over time, rules would need to be developed to provide the timing for recognition of gains and losses on the hedges that do not relate to specific assets, for example an interest rate hedge with respect to a portfolio of bonds.

Some advantages of a capital asset hedging election would be that it represents a less dramatic change in the treatment of non-derivative capital assets than mark-to-market and consequently should be easier for taxpayers to manage; that it is based on an existing election that has worked generally very well; and that it avoids many of the very significant character and other technical issues summarized above and described in more detail below with respect to the Discussion Draft's mixed straddle proposal. As the summary described above demonstrates, however, a capital asset hedging transaction rule would necessarily be complex, and might necessitate the retention and expansion of a number of anti-abuse rules of current law.

There is therefore no clear advantage of one approach over another. We would be pleased to consider further how either or both approaches to mixed straddles could be implemented, if requested to do so.

We note, however, that the Discussion Draft contains a provision treating indebtedness held by an insurance company as ordinary property for purposes of applying the section 1221(b) hedging transaction rules. As a result, an insurance company would be able to identify a hedging transaction consisting of a derivative and a debt instrument and thereby exclude the transaction from the proposed mark-to-market regime. We recommend that consideration be given to extending this treatment to all taxpayers to provide the advantages of a capital asset hedging election described above at least in respect of indebtedness, since the Discussion Draft takes the view that this approach is acceptable for at least some taxpayers.

The remainder of this Part III.C principally discusses the Discussion Draft's mixed straddle proposal.

2. *Scope of the Mixed Straddle Rules; Identification*.

The Discussion Draft proposal applies if one position creates a "substantial diminution of the taxpayer's risk of loss" on one or more other positions. This standard is very vague. Since under the Discussion Draft non-derivative positions will be required to be marked to market if they are part of a mixed straddle, it is essential to know when they are part of a straddle. Examples of fact patterns where it may be difficult to know the answer to that question under the Discussion Draft standard include:

- A taxpayer owns 200 shares, and enters into a short sale on 100 of the same shares. Does the short sale hedge 100% of 100 shares, or 50% of all shares? If the former – which we think is the right answer, and is consistent with current law if the taxpayer properly identifies the shares as part of an identified straddle under 1092(a)(2)[78] – which 100 shares are part of the mixed straddle? The first to be purchased (or sold), the last to be purchased (or sold), or some other subset of the 200? And what happens if the taxpayer sells some of the shares treated as part of the straddle but maintains the 100 share short position?

    - We note that an average basis rule could alleviate some of these issues under the Discussion Draft's proposal. As discussed in Part IV.B below, we do not believe that an average basis rule for securities is desirable.

- A taxpayer owns a $100 million portfolio of fixed-rate corporate bonds. The taxpayer shorts $10 million of Treasuries, for example by entering into "short" Treasuries futures contracts, in order to reduce its exposure to a possible rise in interest rates, or to modify the duration of the portfolio. Alternatively, the taxpayer owns a diversified $100 million portfolio of corporate stock, and enters into a $10 million short futures contract on the S&P 500 index in order to mitigate the risk of a downturn in the economy. Does the short position hedge the entire portfolio? $10 million of the portfolio, and if so which bonds or stocks? Some other fraction of the portfolio?

- A taxpayer owns 100 shares of X stock. In order to generate income from option premiums, the taxpayer sells out-of-the-money call options on 150 shares of X stock. The stock protects the taxpayer against the risk of loss on the call options, because if X stock rises in value the taxpayer will lose money on the call options but make money on the stock. Does the straddle consist of 100 shares/100 options? 100 shares/150 options? Some other fraction of the options?

These issues exist today under the straddle rules, but there is some guidance that taxpayers can look to in determining how to report these transactions, and the stakes for being wrong are lower. Moreover, under current law, taxpayers are permitted to identify assets and their hedges as part of an "identified straddle" under section 1092(a)(2). These rules were adopted in substantially their current form in 2004 precisely to address the types of uncertainty illustrated above. In our view, both more definitive rules for determining when positions are part of a mixed straddle, and identification procedures that allow taxpayers to identify which positions are part of a straddle, are essential to making the mixed straddle rules administrable by both taxpayers and the government.

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[78] *See* Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* 484 n.972 (JCS-5-05, May 2005).

We note in this regard that identification rules can relieve the definitional pressure, to some extent, if taxpayers' identifications are respected. However, because taxpayers have more flexibility to time their gain or loss from capital assets, it is also important to have substantive definitional rules. Those rules could (a) generally provide that assets and hedges are matched on a 1-for-1 basis (*e.g.*, 100 shares/short positions on 100 shares, or 100 shares/call options on 100 shares) or a residual risk basis;[79] and (b) in the cases of hedges of identical assets, like 200 shares of stock, the hedge could be treated by default (that is, absent a taxpayer election to identify other shares) as hedging the same shares that the taxpayer would be treated under section 1012 as selling if the taxpayer sold the shares without specifically identifying them. For portfolio hedges like the bond or stock portfolios described above, the taxpayer could be permitted to follow any method that it uses for other *bona fide* commercial purposes, or any other reasonable method.

As stated above, we consider rules that permit taxpayers to identify which positions are part of a straddle to be essential. Provisions in a prior version of the Discussion Draft defined a straddle for purposes of proposed section 485(c) by reference to the definition in section 1092(c), but specifically carved out the rules relating to identified straddles in section 1092(c)(2)(B). The current Discussion Draft removed this explicit carve out, which we understand to mean that property that is outside the boundaries of an identified straddle under section 1092 will not be treated as part of such straddle for purposes of proposed section 485(c). We would recommend clarification of this treatment in the Discussion Draft, however.

3. *Pre-existing Positions*.

The Discussion Draft proposes that any built-in gain in a position at the time it becomes part of a mixed straddle be accelerated, as if the position had been sold at that point. Positions in respect of "straight debt" and "qualified covered call options" are not subject to this gain acceleration rule. If the position has built-in loss, the loss is determined but not recognized at that point or during the term of the straddle. These rules raise significant technical and policy issues.

- The gain acceleration rule operates like an anti-abuse rule. Mechanically, it is similar to the section 1259 constructive sale rules, which apply when a taxpayer has hedged all or substantially all of its economic risk on an appreciated financial position. But the Discussion Draft gain acceleration rule would apply to many non-abusive cases, for example where a taxpayer hedges

[79] That is, a hedge would be matched to an asset to the extent that it hedged a residual risk after taking previously matched hedges into account. In the first example, after matching 100 short sales against 100 long shares, there is residual risk on the other 100 shares that is not hedged, so the mixed straddle would not include them. In the third case, after matching 100 shares against 100 call options, there would be residual risk on the 100 shares but it would be the risk that the shares will fall in value. Since the other 50 call options do not hedge the taxpayer against that risk (apart from the premiums they generate, which the tax law historically has not taken into account unless the options are in-the-money), they would not be part of the straddle. If the taxpayer subsequently bought 75 put options, they would be matched against the residual downside risk of 75 of the hedged shares. This approach is similar to the one provided by Revenue Ruling 2002-66, 2002-2 C.B. 812. For more extensive discussion of a "residual risk" approach, *see* Erika W. Nijenhuis, *Some Proposals for Interpreting the Tax Straddle Rules*, Tax Forum No. 601 (2007).

only part of its risk, or is hedging aggregate risk (see the second example in the prior subsection).

- Gain acceleration may be justifiable when a taxpayer has locked in the gain. Assuming that the general realization method applies to non-derivatives, however, it does not clearly reflect income to accelerate the taxation of gain arising from non-straddle periods where the taxpayer has not locked in that gain. For example, if a taxpayer owns stock with a $100 value and a $70 basis, and the taxpayer writes a call option with a strike price of $110, the taxpayer is fully at risk that it will lose all $30 of its built-in gains. Alternatively, if the taxpayer buys a put option with a strike price of $80, the taxpayer has temporarily locked in $10 of gain but is at risk with respect to the other $20 of gain.

- A gain acceleration rule would permit taxpayers to elect to accelerate capital gains in order to refresh expiring capital losses, by entering into an offsetting derivatives position on a temporary basis. The IRS recently has issued regulations to prevent taxpayers from carrying out exactly this type of transaction. These rules originally had an immediate effective date, signaling a high degree of concern with the transaction.[80] In our view, if the laws limiting corporate taxpayers' time frame for utilizing capital losses are not repealed – which might be a desirable change of law – then the law should not explicitly provide a means by which well advised and sophisticated taxpayers can refresh them.

We recognize, however, that there is no simple alternative solution. Accelerating both pre-straddle gains and pre-straddle losses would have the same issues described above in the case of gains and would be inconsistent with wash sale and straddle concepts/rules for losses. Suspending both gains and losses would generally seem to be preferable. However, if a taxpayer held an appreciated financial position and hedged all or substantially all of its risk, under current law (section 1259) the taxpayer's gain would be marked to market at the time it enters into the hedge. Eliminating gain acceleration completely would be inconsistent with the judgment on which section 1259 is based that such a transaction effectively is comparable to selling the hedged position – that is, it permits taxpayers to lock-in gains on a market-risk-free basis. We conclude, somewhat reluctantly, that the best alternative is generally to suspend both built-in gains and built-in losses, but to retain section 1259 to deal with the cases Congress has already identified as calling for gain acceleration.

We support the exclusion of "straight debt," which is non-convertible debt that pays interest at a fixed or variable rate (within the meaning of section 860G(a)(1)(B)(i)), and the exclusion of "qualified covered call options" from the built-in gain acceleration rule. The principle behind the exclusion of qualified covered call options (that the taxpayer has not locked in its gain on the stock by entering into the option) applies to a much wider set of transactions,

[80] *See* Treasury Decision 9627, 2013-35 I.R.B. 156 (temporary regulations deferring recognition of both gain and loss for positions that become part of an identified mixed straddle, effective for transactions entered into after Aug. 1, 2013), corrected 78 Fed. Reg. 64,396 (Oct. 29, 2013) (deferring effective date).

and as stated above we would recommend that the Discussion Draft provide for no acceleration of built-in gain in the case of any mixed straddle that would not otherwise be subject to section 1259. If the exclusion is limited to covered call options, we recommend that the exclusion include not only exchange traded options, as in the Discussion Draft, but also "over the counter" ("OTC") options. Regulations under section 1092 treat OTC options the same as exchange traded options for purposes of the existing qualified covered call option rules, and we recommend that the Discussion Draft not reintroduce the distinction between OTC and exchange traded options.

4. *Positions Held Post-Straddle.*

Mark-to-market rules that apply to taxpayers engaged in a trade or business, like derivatives dealers, generally have the result that all positions in a particular line of business are marked to market on on-going basis. When dealing with capital assets, however, there will be many situations where there are temporary hedges, or partial hedges, of assets that will subsequently revert back to the normal rules of the Code. As a result, there are significant timing, character and other technical issues that need to be resolved, and that the Discussion Draft does not address. The Administration proposal provides authority to Treasury to write matching rules for the timing, character, and source of income, but the only example given relates to the source of income. Some examples illustrating these issues are provided here:

- *Ordinary income/capital loss*. A taxpayer owns stock worth $100 and buys an at-the-money put option to protect against the risk of loss on the stock. The stock appreciates to $150 while it is held as part of the mixed straddle, and the put expires. The taxpayer recognizes $50 of mark-to-market ordinary income on the stock. In the following year, the stock falls in value to $120 and the taxpayer sells it.

  Under the Discussion Draft, the taxpayer would have $30 of capital loss on the sale, because proposed section 485(a)(2) provides that proper adjustment shall be made to the amount of any gain or loss subsequently realized on the stock by reason of the $50 of ordinary income recognized with respect to the stock during the mixed straddle. The taxpayer's net economic gain from the stock is $20, but the taxpayer has recognized $50 of ordinary income in the first year and $30 of capital loss in the second year. The taxpayer therefore has both adverse timing and adverse character consequences. If the taxpayer does not have $30 of unrelated capital losses, the taxpayer may be required to pay tax on the $50 of ordinary income without relief.

  If these results are intended, the Discussion Draft Technical Explanation should clearly say so. If they are not intended, some mechanism must be developed to prevent them, such as a recharacterization rule for the $30 capital loss. A mechanism similar to the CPDI rules, which treats loss as ordinary to the extent of prior ordinary income, may be appropriate.[81]

[81] *See* Treasury regulation section 1.1275-4(b)(6).

- *OID/ordinary loss*. A taxpayer owns a bond issued with OID, with an adjusted issue price and basis of $90. The taxpayer enters into a hedge of the bond, and realizes $5 of ordinary loss on the bond during the term of the straddle because the bond falls in value to $85. The taxpayer subsequently sells the bond for $92. Alternately, the taxpayer holds the bond to maturity. (The examples disregard the payment of interest on the bond.)

    - *Sale for $92*. The taxpayer will have $7 of capital gain, because the $2 gain that the taxpayer would have had absent the mixed straddle is adjusted (here, increased) to reflect the $5 ordinary loss. If the taxpayer held the bond for the long-term holding period prior to hedging it, the taxpayer would have $7 of long-term capital gain as a result of the $5 ordinary loss. If it is not intended for the taxpayer to benefit from the rate differential for deducting ordinary losses and taxing long-term capital gain, it would be necessary to provide rules to that effect. For example, $5 of the capital gain might be recharacterized as ordinary.

    - *Hold to maturity*. The taxpayer will have $15 of post-straddle income by the time the bond matures. It is not clear, however, how the "proper adjustment" rule applies to this situation. Does the taxpayer have $10 of OID income and $5 of capital gain? $10 of OID income and $5 of market discount? $15 of OID accrued over the taxpayer's post-straddle holding period for the bond? That is, is the $5 loss treated as affecting the amount of OID, or as an acquisition of the bond for market discount purposes? It appears that neither of those is the case under the Discussion Draft, since the "proper adjustment" rule applies only to the amount of gain or loss taken into account post-straddle. Consequently, it appears that the taxpayer will have, in the aggregate, $5 of ordinary loss, $10 of OID and $5 of capital gain attributable to the reversal of the $5 loss. A more rational result might be to require the $5 gain to be treated as ordinary, and perhaps to require that it be accrued as if the bond had been reissued in the hands of this taxpayer with an $85 issue price.

- *Contribution basis*.[82] A taxpayer holds an asset that it has hedged with a derivative. At a time when the asset has gained $10 in value, the taxpayer contributes the asset to a subsidiary or a partnership and recognizes the $10 of gain on the asset. Does the taxpayer's basis in the stock or partnership interest reflect the fact that the taxpayer has been taxed on the $10 increase in value of the contributed asset? The "proper adjustment" rule does not by its terms affect basis, and it is not clear whether it is intended to apply to gain or loss on

[82] Proposed section 485(d) provides that a derivative will be subject to the rules of proposed sections 485(a) (mark-to-market) and 485(b) (ordinary income/loss) when the taxpayer terminates or transfers the derivative during the course of a taxable year. We suggest that the list of transactions expressly treated as terminations or transfers for this purpose include contributions and distributions

an asset with a substituted basis. If the contributed asset is a bond originally issued and acquired at par, does the $10 increase in value give rise to bond premium on the bond in the hands of the subsidiary or partnership? Is the asset treated as an asset with built-in gain for purposes of section 704(c)? Similar questions would arise if a hedged asset is distributed by a corporation or partnership, or the subject of a gift, or in many other circumstances where basis is an essential tax attribute.

- *Built-in losses*. A taxpayer holds an asset that has a $10 built-in loss at the time it is hedged, which is suspended during the term of the straddle. The taxpayer recognizes $15 of ordinary income during the straddle. When the straddle terminates, how is the $10 loss taken into account? For example, if the taxpayer sells the asset to a related party for its then-fair market value, is the taxpayer treated as selling the asset in a transaction subject to section 267(a) as a result of the $10 built-in loss even though the asset has appreciated by more than $10? If so, how is the $10 loss taken into account for purposes of those rules? Many other rules of the Code addressing the transfer of property with built-in losses also would need to be considered.

We recommend that mark-to-market gain or loss be treated as adjusting the basis of any non-derivative that is part of a mixed straddle. That may also be an appropriate rule for derivatives that are part of a straddle, although that is a more difficult question because of the possibility that a derivative will have a negative value.

The question of how to deal with derivatives that have been marked to market with a negative value is a difficult one. One possibility would be to treat the position as having negative basis. Negative basis is a concept addressed under current law in the consolidated return regulations, but it is not a concept familiar to many sophisticated taxpayers, and would need elaboration. For example, if a position with negative basis is transferred to a corporation or partnership, presumably that transfer should reduce the taxpayer's basis in the stock or partnership interest. Alternatively, a derivative with negative value might be treated as if it were a liability, as would be the case under proposed regulations for purposes of determining the assets and liability of a U.S. branch for interest expense allocation purposes.[83] This concept also would need further elaboration, for example to make clear how to treat such a liability when transferred to another party, including to a corporation or partnership.

More generally, we suggest that consideration be given to treating marking an asset to market under the mixed straddle rules as comparable to selling the asset and repurchasing it for timing and character purposes, albeit without subjecting any straddle period loss as subject to the wash sale, straddle or other anti-abuse rules. Termination of a mixed straddle should not be treated as a sale and repurchase for other purposes. For example, if a taxpayer has held a security for 9 months before it becomes part of a mixed straddle, the taxpayer should retain that holding period once the straddle terminates. The Discussion Draft currently provides that the holding period of a non-derivative built-in gain position does not include the period before such position is treated as sold when the mixed straddle is entered into, but we

[83] Proposed Treasury regulation section 1.882-5(b)(2)(iv), -5(c)(5), *Example (7)*.

think entering into a temporary offsetting position in respect of an appreciated capital asset should not reset the holding period in respect of gain recognized after the offsetting position is exited.

Treating marking an asset to market under the mixed straddle rules as comparable to selling the asset and repurchasing it for timing and character, but not other, purposes would answer many of the questions above. As illustrated above, rules treating post-straddle gain or loss as ordinary to the extent of straddle loss or gain would also be desirable, although consideration should be given to terminating the ordinary treatment of losses if the property is transferred to a related party or in other situations that may give rise to abuse.

5. *Related Parties; Effective Date and Transition Rules.*

This Part III.C.5 considers mixed straddles involving related parties, and effective date and transition issues. Additional mixed straddle issues are discussed in Part III.D.3, below, in connection with debt instruments with embedded derivatives.

Positions held by related parties

The mixed straddle rules should take into account positions held by related parties, under appropriate circumstances. The Discussion Draft incorporates by reference the definition of "straddle" set forth in section 1092(c), but does not specifically reference the straddle related party rules in section 1092(d)(4). We agree that the positions held by spouses (and civil union partners) and members of consolidated groups should be treated as if held by the taxpayer, and vice versa, as provided by section 1092(d)(4)(A) and (B).[84] For positions held by other related persons, such as other family members, other members of a corporate group, partnerships and other pass-through entities, and quasi-pass-through entities like RICs and real estate investment trusts, it is likely that there will be many circumstances in which it is not appropriate to treat those positions as held by the taxpayer. On the other hand, it seems likely that positions held by such taxpayers might be used to avoid the mixed straddle rules in some cases. Accordingly, we recommend that positions held by such related parties be treated as held by a taxpayer, or that positions held by a taxpayer be attributed to such related parties, where the positions are held as part of a single transaction or related transactions with a view to avoiding the application of the derivatives mixed straddle rules. Alternatively, a rule of this kind might be adopted as a general presumption rule, not limited to related parties, in addition to the presumptions provided by section 1092(c)(3).

If positions are attributed to or from a related party in the absence of an intent standard, taxpayers should be permitted to identify which positions are part of the mixed straddle, as discussed earlier, and there should be ordering rules that apply in the absence of an identification. Examples of such ordering rules could be that positions held by a single legal entity are matched against each other before taking into account positions held outside the legal entity; and that positions held by related U.S. taxpayers are matched against each other before taking into account positions held by related non-U.S. taxpayers. Rules similar to those that

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[84] Section 1092(d)(4)(C) expands the related party rules to flowthrough entities, but is not comprehensive. While Treasury regulation section 1.246-5(c)(6) further expands the scope of the rules, and section 7701(*l*) provides additional authority, it would be preferable for the statutory rules to be rationalized.

apply to hedging transactions between consolidated group members also should apply to intercompany transactions involving mixed straddles.[85]

Consideration also should be given to the effect of the mark-to-market rules in situations where an affiliate is subject to different tax rules. For example, if a U.S. taxpayer enters into a derivative that is treated as creating a mixed straddle with a position held by a CFC, gain on the CFC's position might give rise to subpart F income while a loss at the CFC level might be functionally non-deductible. Conversely, a U.S. subsidiary of a foreign parent might be able effectively to elect into mark-to-market of an asset if a foreign affiliate entered into a hedge of that asset. Other considerations may be relevant if a member of a U.S. group is subject to special tax rules, for example an insurance company, a dealer in securities, or an affiliate with losses subject to the separate return limitation year rules.

Effective date; transition rules

Proposed section 486 provides that it would apply to taxable years ending after December 31, 2014 for property acquired and positions established after December 31, 2014 (including property that becomes part of a section 485 straddle after this date) and to taxable years ending after December 31, 2019 for all other property and positions. We assume that the first effective date will be postponed to a date that provides adequate time for taxpayers to develop new procedures and computer systems. Some taxpayers may prefer to mark to market all of their derivatives as of the first effective date, rather than only new ones. Taxpayers should be permitted to elect to do so, subject to an appropriate section 481 adjustment.

D. Embedded Derivatives

The Discussion Draft provides that the term "derivative" includes an embedded "derivative component" of a larger contract. Each derivative component is treated as a separate derivative, unless the derivative cannot be separately valued, in which case the entire contract is treated as a derivative. A "derivative component" is not defined by the Discussion Draft.

The Discussion Draft provides that a debt instrument is not treated as having an embedded derivative component "merely because" the debt instrument is denominated in a nonfunctional currency (or has payments made by reference to a nonfunctional currency) or is a convertible debt instrument, a CPDI, a VRDI or a debt instrument with alternative payment schedules. Under the Discussion Draft, convertible debt instruments would be subject to rules comparable to the rules for CPDIs.

The Administration has proposed a similar but broader rule. It states: "A derivative contract that is embedded in another financial instrument or contract would be subject to mark to market if the derivative by itself would be marked to market." The description of the proposal makes clear that it would apply to CPDIs and structured notes linked to actively traded property.

We discuss in this Part III.D technical and policy issues relating to the scope of the embedded derivatives proposal.

85 *See* Treasury regulation section 1.1221-2(e) (hedging by members of a consolidated group).

1. *Technical Issues*.

The scope of the Discussion Draft proposal has proved difficult to discern, as a result of the use of the “merely because” formulation. Some taxpayers believe that the effect of the proposal is that CPDIs, etc., generally are subject to the embedded derivative component rule – that is, that the “merely because” formulation simply means that CPDIs are not automatically treated as having embedded derivatives, but instead must be evaluated on a case-by-case basis. We refer to this as the “broad” reading of the Discussion Draft proposal. Other taxpayers believe that reading the proposal in that manner renders essentially meaningless the exclusion of CPDIs, etc., from the scope of the rule. In this alternative reading, most debt instruments with embedded contingencies are excluded from the scope of the rule, and it is left unclear to what debt instruments the rule might apply. We refer to this as the “narrow” reading of the Discussion Draft proposal. The intended meaning of the rule should be clarified.

There is also some ambiguity about the scope of the Administration proposal, as a result of the qualifier that embedded derivatives are subject to the mark-to-market/ordinary regime only if the derivative by itself would be marked to market. For both this proposal and the broad reading of the Discussion Draft, critical questions include whether ordinary course contingencies routinely embedded in the terms of debt instruments are intended to be bifurcated and whether the effect of the embedded derivative component rule is to treat multiple embedded derivative components as a single separate hypothetical derivative or multiple hypothetical derivatives.

Ordinary course contingencies

Ordinary course contingencies routinely embedded in the terms of “plain vanilla” debt instruments include:

- An issuer/borrower option to pay the debt instrument in whole or in part prior to its stated maturity (a “call option” for a bond, or prepayment right for a loan or mortgage).
    - In some cases, the early redemption price is fixed by the terms of the debt instrument, generally at a higher price in earlier years, declining to par.
    - In other cases, the early redemption price is determinable based on a “make-whole” formula, which provides for an amount that is intended to protect investors against reinvestment risk, and is calculated as the greater of par or the value of remaining payments based on a specified discount rate.
- An option by holders to put the bond back to the issuer in the case of a change of control (a “change of control put”) – that is, the right by holders to force early redemption, usually at a price higher than par.

- An obligation on the issuer's part to pay additional interest to foreign investors if withholding rates rise.

- An obligation on the issuer's part to pay additional amounts if a bond issued under Rule 144A does not become freely tradable for securities law purposes within a specified period of time, or if the issuer ceases to file financial reports with the Securities & Exchange Commission for a period of time.

- An option on the part of a borrower under a loan to change the floating rate basis on which it pays, *e.g.*, switching from LIBOR to a Fed Funds rate.

- Conceivably, a debt instrument with floating rate payments also could come within the scope of the embedded debt component rules, on the theory that the debt instrument has an embedded interest rate swap, or an embedded series of payment options.

In a number of cases, these contingencies typically are viewed as "remote" contingencies and are ignored until and unless they happen. In other cases, the rules for VRDIs or debt instruments with alternative payment schedules apply. We suspect that none of these terms were intended to be treated as stand-alone derivatives. If so, that should be clarified. Other rules dealing with specific types of debt instruments subject to special rules, such as demand loans, debt instruments with "resettable" interest rates, and debt instruments subject to section 1272(a)(6) also should be addressed.

Convertible bonds

The Discussion Draft would treat convertible bonds comparably to CPDIs (raising the same questions about the "merely because" language as discussed above), while the Administration proposal would presumably treat the embedded derivative component(s) as a stand-alone derivative. Under either proposal, if the embedded derivative component of a convertible debt instrument were required to be treated separately, there is some ambiguity in discerning the exact terms of the component(s) that would be treated as such. A convertible bond may provide that an investor can exercise its conversion right at any time. Alternatively, it may provide that an investor can exercise the right only (i) at a date that is close to the maturity of the bond and (ii) prior to that time, in certain specified circumstances in which it is thought that investors may prefer to hold the issuer's stock. We are not aware of stand-alone options that have terms like those described in the prior sentence. If the convertible bond has a long-dated maturity, it typically also will provide that the issuer may call the bonds after a stated period of time. In practice, this call right operates as a means for issuers to encourage investors to exercise their conversion right, so that while nominally separate from the conversion right – and a standard term of "plain vanilla" bonds – the call right in fact is inextricably linked to the conversion right as an economic matter. Finally, the number of shares into which the bond may be converted is subject to adjustment in the case of various corporate actions. These adjustments do not precisely track the kind of adjustments that are made to stock options or warrants entered into on a stand-alone basis. It is not clear from either the Discussion Draft or the Administration proposal which of these various forms of contingencies are to be treated as stand-alone derivatives.

Treating convertible bonds as CPDIs, as the Discussion Draft provides, raises a number of ancillary technical issues. Permitting issuers to take deductions in excess of the interest or conventional OID on a convertible bond raises additional issues, because that interest or OID can be viewed as a cost of issuing an instrument based on the issuer's own stock, which generally does not give rise to gain or loss to the issuer.[86] This could be addressed by clarifying that under section 249, the issuer's deduction is capped at the convertible bond's comparable yield, even if the value of the stock delivered on conversion exceeds the adjusted issue price under the CPDI rules.[87] Additionally, the treatment of convertible bonds should be coordinated with section 305. If new regulations are to be promulgated specifically to address convertible debt, it may be desirable to address income from the adjustment of conversion ratios in the context of those regulations, so that there is no uncertainty as to whether an adjustment to a conversion ratio of a CPDI gives rise to a deemed dividend to the convertible bond holder under section 305(c).

Scope of application and extraction of embedded derivative components

Because the Administration's proposal applies to derivatives embedded in any financial instrument or contract, it gives rise to additional questions about scope. The first results from the fact that the term "financial instrument or contract" is not defined. Portfolio stock presumably is a financial instrument. An insurance policy presumably is as well. The outer bounds of the term are not certain, though. The Discussion Draft applies only to a "contract" with an embedded derivative component, which we assume would exclude portfolio stock, but could include an insurance policy.

A second issue has already been noted, namely the question of whether bifurcation of embedded derivative components results in one derivative or multiple derivatives. For example, in the case of a structured note not treated as debt for tax purposes, the payout on the note may be the result of a formula that takes into account the performance of multiple assets. The note may be callable if certain financial triggers are hit, for example if the underlying asset trades above or below a specified level, or the payment terms of the instrument in a later period may depend on the performance of the note or the underlying assets in an earlier period. For a complex structured note of this kind, it is highly likely that there is no single stand-alone derivative financial instrument with similar terms.

On the other hand, if the instrument is decomposed into multiple financial instruments, how is the carving up to be done? There are likely to be multiple alternatives. One might attempt to answer these questions by looking to how the dealer issuing the instrument analyzes it in order to hedge it, but it may well be the case that the dealer does not decompose it into separate hypothetical financial instruments for that purpose. Thus, there is no obvious or easy way to determine how to extract the embedded derivative components.

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[86] New York State Bar Association Tax Section, *Report on the Taxation of Straight and Contingent Convertible Debt*, Report No. 1022 (Nov. 7, 2002), at 4-7, available online at http://old.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1022report.pdf (last accessed on March 14, 2014).

[87] This result is consistent with Revenue Ruling 2002-31, 2002-1 C.B. 1023.

A third issue is how an embedded derivative would be valued. The valuation of embedded derivatives raises all of the issues raised by the valuation of actual derivatives, plus the additional valuation challenges that will be presented if an embedded derivative does not exist in stand-alone form in the market at all.

As this discussion illustrates, if debt instruments, or other financial instruments or contracts, are required to be decomposed so that the embedded derivative can be marked to market, we think some form of information reporting would be necessary in order to ensure that holders have readily available information on the valuation of the embedded derivative. Because neither the embedded derivative nor the host contract may exist as a stand-alone instrument, it would also be important that reasonable valuations be respected. For example, taxpayers should be permitted, and perhaps required, to decompose and value contingencies in the same manner that they do for financial accounting or regulatory purposes, if they do so. GAAP also could provide some guidance in determining what types of contingencies should not be treated as embedded derivatives required to be marked to market. For example, we understand that GAAP does not require issuers to break out contingencies that are clearly and closely related to the debt characteristics of a debt instrument.

2. *Policy Issues*.

As a policy matter, it is inviting to treat derivatives in the same manner regardless of whether they are embedded in another financial instrument or not. That is particularly true because taxpayers can structure financial instruments in myriad ways, many of which have similar terms as an economic matter. For example, a bond/warrant unit (a unit composed of a bond plus a warrant or option) may have economics similar to a convertible or exchangeable bond. Moreover, any alternative that treats some instruments with embedded derivatives as subject to mark-to-market/ordinary treatment, and others as not, creates significant cliff effects.

On the other hand, the technical issues discussed above are not merely technical. The examples illustrate the difficulty of extracting from a financial instrument payment rights that may have economic connections to other terms of the instrument; and the uncertainty created by the multiplicity of ways to construct a financial instrument. Those issues can be addressed, in principle, by extracting all such terms and treating them as a single derivative. Doing so increases the risk, however, that the extracted derivative is one that does not exist on a stand-alone basis and therefore does not have a reliable valuation. These very difficulties in determining what the comparable stand-alone financial instrument should be led to the abandonment of a prior attempt to bifurcate debt instruments with contingent payments in the early 1990s, and to the development of current law's rules for CPDIs, which although not well loved are reasonably well understood.[88]

[88] Regulations were proposed in 1991 that would have required certain debt instruments with contingent payments to be separated into contingent and noncontingent components. Each component would have been required to be taxed as it would have been had it been issued as a separate instrument. Notice of Proposed Rulemaking, *Debt Instruments with Original Issue Discount; Contingent Payments*, 1991-1 C.B. 834. These regulations proved unworkable, and were abandoned a few years later. *See* Notice of Proposed Rulemaking, *Debt Instruments with Original Issue Discount; Contingent Payments*, 1995-1 C.B. 894.

It does not appear possible to us to reconcile these concerns. A choice must be made of whether to apply a broad or narrow rule, and then an attempt must be made to mitigate the consequent difficulties that this choice brings with it. In our view, however, there may be better alternatives than the ones proposed in the Discussion Draft and by the Administration.

An alternative narrower approach would be to rely in the first instance on existing rules that apply to debt instruments having contingent payments of one kind or another. Under this approach, debt instruments subject to the CPDI rules, the VRDI rules, or other rules of sections 1271-1275 generally would continue to be subject to those rules. This is compatible with the "narrow" reading described above. Under this alternative, treatment of convertible bonds as CPDIs would largely remove debt instruments from the embedded derivative component rules, as principal-protected structured notes typically are subject to one of the section 1271-1275 rules.

For debt-like financial instruments that do not qualify as debt instruments for tax purposes, such as structured notes that do not have meaningful principal protection, there are at least three options that do not involve extracting embedded derivative components, as contemplated by the Discussion Draft: (a) retaining the "wait-and-see" method of current law; (b) requiring the accrual of income pursuant to the CPDI rules or other similar rules;[89] or (c) marking the entire instrument to market.[90]

We assume that the first alternative is not consistent with the goals of the Discussion Draft and Administration proposal.

The second alternative has the advantage that it most closely resembles the rules that would be likely to apply if the same instrument were principal-protected, thus eliminating current law's distinction between otherwise similar financial instruments. It also does not require any valuations, although it can have complexities of its own.[91]

The third alternative has the advantage that it is most similar to the mark-to-market rule that generally would apply to derivatives. The Discussion Draft applies the third

89 *See* H.R. 4912 (Dec. 19, 2007) (would require interest accrual on prepaid derivative contracts), available online at http://www.gpo.gov/fdsys/pkg/BILLS-110hr4912ih/pdf/BILLS-110hr4912ih.pdf (last accessed on March 13, 2014).

90 If any of these alternatives is adopted, consideration should be given to expanding the rules to apply to bond/warrant units, or more generally units consisting of two nominally separate instruments that in practice are offered and trade together as a single unit. To the extent that units of this kind in fact are treated by the market as, and behave like, a single financial instrument, they should be taxed in the same manner as a single financial instrument. For example, the financial instruments described in Revenue Ruling 2003-97, 2003-2 C.B. 380, are described in the market as "mandatory convertibles," and the two components of the instruments rarely are separated in practice, although separation is possible and occasionally takes place. If rules of the kind described in the text applied to a mandatory convertible as if it were a single financial instrument, it might be necessary to include provisions dealing with those situations where the components are in fact separated. *Cf*. Section 1286 (rules for "stripping" transactions, where components of a single debt instrument are separated into separately traded instruments).

91 *See* Joint Committee on Taxation, *Present Law and Analysis Relating to the Tax Treatment of Derivatives* 32-34 (JCX-21-08, March 4, 2008) (difficulties include potential taxation of accruals in respect of amounts that will never be received, if principal protection is no longer the dividing line between interest accrual and nonaccrual).

alternative above only when the embedded derivative component in a contract cannot be separately valued.

Another possible alternative to the Discussion Draft approach would be to require one of the alternatives above to be treated as the default rule, but to allow taxpayers to elect a different method if it is easier for them to comply with it. For example, the default rule might be mark-to-market, but taxpayers might be permitted to elect the accrual alternative, if they did so on a consistent basis.

Members of the Tax Section's Executive Committee generally agreed that it was undesirable to require the bifurcation of embedded derivatives, at least for holders. We did not reach agreement as to which of the possible alternatives above should be recommended. We also observe that, while there are benefits to issuer/holder symmetry, the pros and cons of the methods described above are different for issuers and holders, so that a final possibility would be to permit, or require, different rules for issuers and holders.

3. *Mixed Straddles Involving Debt with Embedded Contingencies*.

The Discussion Draft's mixed straddle rules can apply to straddles in which derivatives hedge liabilities as well as straddles in which derivatives hedge assets. While it may often be the case that such transactions are eligible for a section 1221 hedging transaction election or an election under section 988(d), that may not always be the case or the taxpayer may fail to make the election. Examples of such transactions include:

- a CPDI that provides for payments by reference to third party stock, and that is hedged through one or more options on that stock;
- a foreign currency denominated debt instrument and a cross-currency swap of that debt instrument;
- an exchangeable bond issued by a U.S. subsidiary on stock of a foreign parent that is hedged by an option to buy the stock from the parent.
- a debt instrument issued by a special purpose vehicle ("SPV") with payments linked to a particular asset, where the SPV's assets consist of a debt instrument and a swap that transforms the payments on the debt instrument held by the SPV into the payments owned by the SPV on the debt instrument it has issued. In this example, the swap might be viewed as a hedge of either the debt instrument held or the debt instrument issued.

Since in each of these cases a debt instrument is, or may be viewed as, hedged by a derivative, it appears that the debt instrument would be required to be marked to market under the mixed straddle rules. The effect of that would be to mark not only the derivative component, but also the debt component. As noted above, since the debt component is a liability, this would be a novel rule. In this situation, if the stand-alone derivative is closely related to the derivative embedded in the debt instrument, marking the stand-alone and embedded derivatives to market is a more attractive proposition, since the valuation of the former should inform the valuation of the latter. Taxpayers should be able to determine which derivatives fall within this scope under any reasonable method, including by following their financial accounting treatment.

E. Derivatives on an Issuer's Stock

Under the Discussion Draft, income, gain, loss and deduction from derivatives relating to a corporation's own stock would be subject to nonrecognition treatment under section 1032. We think this provision is a desirable clarification of the application of section 1032 to such derivatives. We note, however, that difficult questions will be raised by the application of this rule to more complex derivatives on both the issuer's stock and some other asset (*e.g.*, a derivative on a basket of stocks that includes the issuer's).

Additionally, the Discussion Draft provides that derivatives in respect of the stock of members of a corporation's worldwide affiliated group would be excluded from the definition of "derivative" under proposed section 486 (and thus from the new mark to market rule). We think this is a sensible approach to excluding derivatives arising from intercompany restructurings and other transactions, although it falls short of excluding derivatives arising from many ordinary M&A transactions.

As noted earlier, we support the Discussion Draft's proposal to tax a corporation on income derived from acquiring its stock and, pursuant to a plan, selling it under a forward contract, subject to comments we have previously submitted.[92] One additional change to the treatment of contracts in respect of an issuer's stock contained in the Discussion Draft is beyond the scope of this report: warrant premium would be included in gross income under proposed section 76.

IV. **Basis of Securities Proposal**

Section 3421 of the Discussion Draft proposes to amend section 1012 to provide that on the sale, exchange or other disposition of a "specified security," the basis of the security will be determined under a FIFO method. The term "specified security" is defined in current section 1012(c)(3), by cross-reference to section 6045(g), as any share of stock, any evidence of indebtedness, and other financial instruments designated by Treasury. Consistent with section 6045 and the regulations thereunder, this rule applies on an account-by-account basis.

The Administration has proposed a different rule, closer to the proposal in the prior version of the Discussion Draft. The Administration proposal would mandate an average basis method, applicable only to "portfolio stock" that has a long-term holding period. The Administration proposal requires that average basis be determined by taking into account all identical shares held by the taxpayer, regardless of the accounts in which the stock is held, other than nontaxable accounts like retirement accounts. The Administration proposal thus leaves as is the specific identification method of current law for securities other than portfolio stock held for a long-term holding period. Authority is provided, however, to expand the average basis rules to stock other than portfolio stock, and to coordinate the rules with the rules for basis in stock in a passive foreign investment company.

[92] *See* note 5, *supra*.

This Part IV discusses whether a single method for determining basis should be required, and if so for which securities; and whether a single method should apply on an account-by-account basis or across taxable accounts. We then discuss the advantages and disadvantages of FIFO vs. average basis.

A. Single Method for Determining Basis

1. *Whether a Single Method Should be Mandated*

Under current law, taxpayers that have acquired different lots of securities at different costs have a range of choices for determining basis when they dispose of some but not all of those securities. The default rule under section 1012 is FIFO, meaning that the taxpayer is deemed to have sold the securities with the longest holding period. The taxpayer may elect to specifically identify the securities as the securities acquired on a specific date, or, as a variant on specific identification, may elect to use a variety of other methods, including "last in first out" ("LIFO"), highest basis first, or "least tax" (taking into account holding period as well as basis) first. In some limited cases, the taxpayer is expressly permitted to use an average basis method, for example for stock of a RIC acquired through a dividend reinvestment plan.

As discussed in more detail below, reasonable arguments can be made in favor of many of these rules, on a rule-by-rule basis. It seems improbable, however, that simultaneously allowing all of these rules to be used constitutes the "right" way to determine basis. Moreover, the result of the electivity permitted by current law is that a well-advised taxpayer always "wins" and the fisc always "loses." It is fair, therefore, to consider whether a single rule should be mandated, and if so, for what types of securities. It is also important to consider the effect of any such rule on the holding period of the securities that the taxpayer is deemed to have sold.

In considering these questions, we have taken into account the fact that in a world in which most securities are held in book-entry form, there is typically no difference between one security and another security of the same kind, other than for tax purposes. That is not invariably true – there may be securities law or other legal distinctions between securities acquired at different times, for example. Even in those cases, however, there is rarely a permanent economic difference between any two specific shares or any two specific bonds of the same issuer.

We also have taken into account that (i) significant basis differences are more likely with respect to stock than with respect to debt, because stock typically varies in value more and with more volatility than is the case for debt instruments; (ii) it can be difficult to ascertain the purchase price of every security of a particular kind acquired over a period of years, particularly in the case of portfolio stock and particularly where there are many purchases and sales of that stock over time; (iii) under current law, the basis of a security may be different for different purposes, for example the basis of gifted shares may differ depending on whether the recipient taxpayer has a gain or loss on the disposition of the shares;[93] (iv) basis rules must be

[93] Section 1015(a) (if taxpayer receives shares as a gift and the pre-gift basis of their shares exceeds their fair market value at the time of the gift, basis of shares equals that fair market value for purposes of determining loss but not for purposes of determining gain). As an example of how these rules might interact with an average basis regime, assume that a taxpayer owns 100 shares of ABC stock with a basis of $20/share. The taxpayer receives as a gift another 100 shares of ABC stock. At the time of the gift, the shares have a value of $36/share, but the donor had

coordinated with holding period rules; (v) in this area, administrability concerns are extremely important; and (vi) it is not realistically possible under current market practice both to have rules that take into account securities held in accounts with different brokers and also to have basis reporting rules that provide accurate information on an account-by-account basis, since a broker can report only what it knows. These points are discussed in more detail below when we review the advantages and disadvantages of several possible basis determination methodologies.

We believe that the case for mandating a single method for determining basis is strongest for stock, as proposed by the Administration, as there is a high degree of electivity and no economic distinction between one share and another. The case for mandating a single method for determining the basis of debt is weaker, given the disadvantages associated with alternative basis methodologies and the lower benefit to the fisc likely to be obtained in view of the lower volatility in the price of debt instruments. In the case of non-portfolio stock, we have a different concern, which is that basis is so fundamental to the operation of the subchapter C rules and international tax rules that there may be unexpected consequences to changing those rules without further study.[94] Rules in other parts of the Code, for example subchapter K, subchapter S and the estate and gift tax rules, could also be affected. We would be pleased to consider those issues further if so requested.

2. *How Securities Held in Different Accounts Should Be Treated*

Another fundamental issue highlighted by the differences between the Discussion Draft proposal and the Administration proposal is whether a single-method basis should be determined on an account-by-account basis, or across all taxable accounts. The latter is clearly preferable from a theoretical perspective, because it reduces taxpayers' ability to determine basis on what can in practice be an elective basis. Allowing taxpayers to determine basis on an account-by-account basis potentially undermines the premise of a single method system, because taxpayers that wish to continue to use specific identification can simply set up a new account whenever they acquire additional securities. Taxpayers that can manage the complexity of multiple brokerage accounts have complete electivity, while other taxpayers have none. We

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a basis of $40/share. The taxpayer holds onto all 200 shares. Is the average basis for the shares $30/share (= ($20 + $40)/2) or $28/share (= ($20 + $36)/2)? Since the independent basis of the shares received as a gift depends on the price at which they are sold, it seems that the answer would differ depending on whether the taxpayer sells the shares for more or less than $36/share. That in turn means that, depending on the share price at the time of sale, the average basis of all of the shares would be different. That would be difficult to keep track of, particularly if the taxpayer has many other transactions in ABC stock. Note also that unlike the case with a FIFO or specific identification rule, the taxpayer would be subject to this fluctuating basis rule until it sold all of its ABC shares.

[94] A disadvantage of our proposal is the need to define what constitutes "portfolio" stock. There are multiple possible approaches to that question. One possibility might be to define portfolio stock as stock that is publicly traded and that is not held by a shareholder who is required to file information returns with the Securities and Exchange Commission as a result of the size of its holdings (e.g., a five-percent shareholder). Other possible places to draw the line would be at 20 percent, by reference to the section 243 and affiliated group definitions. The definition should serve to exclude any shares held by sophisticated shareholders or in more complex transaction structures. These issues are discussed in more detail in another recent report. *See* New York State Bar Association Tax Section Report No. 1316, *Report on Proposed Regulations Regarding Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities* (February 6, 2015), *available at* http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2015/Tax_Section_Report_1316.html (last checked March 2, 2015).

believe that current law, which provides all taxpayers the same opportunity for electivity, is preferable to a system of that kind.

On the other hand, since a securities broker can report only the information that it has, requiring taxpayers to determine basis across their taxable accounts makes it very likely that there will be a discrepancy between the basis reported to taxpayers and the basis that taxpayers are required to use for purposes of determining gain or loss. This is particularly problematic for taxpayers with several accounts managed by independent investment managers, because it may not be possible for any person to know the basis of the taxpayer's securities until after the end of the year when information can be reconciled.

A third consideration is that Congress mandated a few years ago that brokers provide cost basis reporting for securities, and those rules have been implemented by brokers over the last few years.[95] Cost basis reporting is expected to address the problem that taxpayers may not know, or may choose improperly to report, the basis of equity and debt securities that they hold in brokerage accounts. Improper reporting of basis by taxpayers was singled out as a non-trivial part of the tax gap. It is possible, therefore, that the new reporting rules will alleviate many of the real-world problems associated with the basis of portfolio securities. There may be a benefit to letting these new rules take effect and evaluating them before making further changes. These cost basis reporting rules apply on an account-by-account basis.

As discussed in more detail below, the relative advantages and disadvantages for account-by-account versus across-all-accounts approaches play out differently for different single methods. As a general matter, the effective electivity of an account-by-account approach could largely undo the benefits of mandating a single method for determining basis. We question therefore whether it makes sense to adopt a single method without applying it across all of a taxpayer's accounts. On the other hand, the administrative complexity and potential for taxpayer misreporting that results from a single method applied across all of a taxpayer's accounts is justifiable only if the single method in question represents a significant improvement over current law. As discussed in the next section, we are not confident that any given method represents a sufficient improvement to warrant changing current law.

In any case, if an across-all-accounts approach is taken, then we recommend that broker reporting rules be instituted to reduce the administrative complexity and counter the risk of taxpayer misreporting. In the case of an average basis rule, we recommend that each broker be required to report annually the average basis of all shares held by the taxpayer in order to reduce the information problems raised if a taxpayer holds the same securities in multiple accounts at multiple brokers. That will give the taxpayer, and the IRS on audit, the information necessary to determine the average basis of those shares across those accounts when a taxpayer sells some but not all of its shares of a particular issuer and class. If a FIFO approach is applied across all accounts (an approach that, as discussed in the next section, we do not endorse), then a similar rule may be called for – that is, reporting of the basis of each lot of shares held by a taxpayer.

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[95] *See* Section 6045(g); section 6045A; section 6045B; and regulations thereunder.

If a single mandated basis methodology is adopted across taxable accounts, whether FIFO or average basis, the rules also should take into account that a taxpayer may be able to isolate the basis of particular shares by transferring them to a separate legal vehicle that it controls. In that case, rules may be necessary to prevent taxpayers from effectively creating separate accounts through the use of separate legal entities.

However, if a taxpayer holds accounts at multiple financial institutions, and one or more of those accounts is managed by an independent manager that manages securities for multiple unrelated taxpayers and that does not coordinate its purchase and sale decisions with the taxpayer or its agents, consideration should be given to allowing the taxpayer to treat the securities managed by that independent manager as if they were held by a separate taxpayer. In a case like this, it may be functionally impossible for a taxpayer to determine basis of all of its securities under any single method. It is also unlikely that taxpayers can game the system if the manager is independent and does not coordinate its actions with other purchases and sales made by the taxpayer.

B. Pros and Cons of Alternative Single Methods

We have considered several different alternative single methods and account rules. We discuss below (i) average basis, across all accounts, (ii) FIFO, on an account-by-account basis, and (iii) current law. While there are other possibilities, we think they would be more disadvantageous than any of these alternatives.

As described above, we recommend, if any single method is mandated for determining basis, that additional consideration be given to the effect of such a rule on subchapter C, the Code's international tax rules, and other non-financial product rules, before the single method is extended to securities other than portfolio stock.

1. Average Basis Method

The principal advantage of an average basis method has already been referred to. In a world in which portfolio securities are usually entirely fungible with each other, an average basis method more closely reflects economic reality, although as previously noted only a mark-to-market system for securities would truly reflect economic income or loss from an investment in securities. This is a powerful argument in favor of an average basis method.

However, there are also significant disadvantages. One is that the method "works" only if a taxpayer has perfect and complete information about all of the securities of a particular type that it owns. There may be many situations where that is not the case. A lack of information about a small number of securities would make it technically impossible for a taxpayer to know the basis of any of the securities of that type that it owns. Moreover, even if the information is available, it may be burdensome to determine, or conflict with perceived "real" gain or loss. Transactions in which a taxpayer repeatedly buys and sells the same securities within a short period of time could give rise to numerous complex calculations if the taxpayer also happens to hold some of the same stock on an indefinite basis.

Other fact patterns in which an average basis methodology could give rise to unexpected results arise when a taxpayer acquires stock pursuant to an option and then immediately sells it. These fact patterns arise in the case where the taxpayer has a fair market value basis in the newly acquired stock, and holds other low-basis shares of the same stock. For example, an employee of a public company that exercises a standard non-qualified compensation option that entitles the employee to buy stock of the company generally will have compensation income on exercise of the option equal to the value of the stock less the amount paid for it. It is common for such employees to sell some of the newly acquired stock in order to pay their tax liability. If taxpayer A exercises a non-qualified option and acquires 100 shares of stock with a total value of $1000 for an exercise price of $1/share ($100), and the taxpayer is subject to tax on $900 of income, under current law the immediate sale of some of that stock does not give rise to gain or loss, because the taxpayer has a fair market value basis ($10/share) in the stock. Under an average basis regime, if the taxpayer already holds another 100 shares of the company's stock with a basis of $200 ($2/share), the average basis of the 200 shares will be $6/share (=($1000 + $200)/200), and the sale of some of the option stock for its $10/share fair market value will give rise to gain even though taxpayer A had no meaningful period of investment in those shares. The taxpayer would have to sell additional shares in order to raise the after-tax amount necessary to pay the tax on the exercise of the option. Another example with the same type of tax consequences – *i.e.*, the acquisition of stock pursuant to an option that is treated as a fully taxable transaction – is the exercise of an option to acquire public company stock in exchange for partnership units as part of an UPREIT or "UP-C" transaction. Typically a taxpayer would exercise an option of that kind in order to sell the stock. Again, even though on a stand-alone basis the taxpayer would have a fair market value in the stock and therefore would realize no gain or loss on the sale, under an average basis regime the taxpayer would have gain or loss if it held other shares of the company.

Another significant issue is that average basis rules do not mesh well with holding period rules. Consider for example a taxpayer that bought 100 shares for $60/share ($6,000) two years ago and 200 shares for $15/share ($3,000) six months ago. The total basis of these shares is $9,000, and the average basis of those shares is $30 (=$9,000/300). The taxpayer sells 30 shares for $75/share ($2,250), realizing a gain of $45/share ($1,350 = $45 x 30). There are several possible ways to determine whether this gain is short-term or long-term. For example:

1) The gain could be treated as long-term or short-term by reference to the relative holding period of all of the shares, weighted by number of shares. In that case, 1/3 of the $1,350 gain, or $450, would be treated as long-term and 2/3 of the $1,350 gain, or $900, would be treated as short-term. This does not give the same result as selling 10 long-term shares and 20 short-term shares under current law. It overstates the amount of "actual" long-term gain compared to gain on the sale of 10 long-term shares under current law by a considerable margin. Under current law only $150 gain ($15 gain/share = $75 sales price - $60 basis) would be treated as long-term. In effect, gain has shifted from short-term shares to long-term shares.

2) The gain could be treated as long-term or short-term by reference to the relative holding period of all of the shares, weighted by the basis of each share. In that case, 2/3 of the gain ($900) would be treated as long-term and

1/3 of the gain ($450) would be treated as short-term.[96] This overstates the amount of "actual" long-term gain by an even greater margin than the first alternative.

3) The gain could be treated as long-term or short-term on a LIFO or FIFO basis, that is, for holding period purposes only, deeming the taxpayer to have sold either the 6-month shares or the 2-year shares. On a LIFO basis, all of the gain would be short-term. On a FIFO basis, how much of the gain is treated as long-term depends on how many of the 2-year shares one takes into account.

   - If one takes into account only the potential gain on the sale of 30 of the 2-year shares (30 x ($75-$60) = $450), that gain is less than the taxpayer's actual gain (30 x $45 = $1350). There is no particular logic to how the remaining gain ($900) should be treated.

   - If instead one takes into account the potential gain on the sale of all of the 2-year shares, then all of the gain would be long-term. In effect, gain would have shifted from unsold 2-year shares to sold 2-year shares.

As these examples illustrate, it is difficult to come up with a right answer unless an average basis rule applies only to securities with a long-term holding period, as proposed by the Administration. That proposal creates a different kind of complexity, which is that the average basis of a taxpayer's long-term securities will change as securities age from short-term to long-term. Moreover, if a taxpayer makes multiple purchases of the same securities during a single year, then in the following year the average basis of its long-term shares will change at each of the one-year anniversaries of those purchases.

These complexities would give rise to significant administrability concerns. Moreover, if an average basis method is adopted, the rationale for doing so is that each (long-term) share owned by the taxpayer is economically identical to each other share of the same class. Accordingly, the principle underlying the average basis method leads to the further conclusion that the method should be applied across all of a taxpayer's accounts. Doing so is likely to give rise to additional complexity and a greater risk of taxpayer misreporting (whether intentional or not). We have very strong concerns about the difficulty of harmonizing average basis across accounts with basis reporting. In practice, unless all information about a taxpayer's securities is required to be reported, and can feasibly be reported, to a single aggregator of that information, the loss of accurate information about the taxpayer's basis could undermine the theoretical benefits of an average basis approach. There is no comparable system today, although conceivably technology could make it possible in the future. By comparison, OID on publicly issued bonds – which is typically determined once, on issuance – is reported to the Service and then reported by the Service to the public. Although we believe that an average basis approach, applied only to securities with a long-term holding period, represents an

[96] The 100 shares purchased 2 years ago for $60/share have a total basis of $6,000, while the 200 shares purchased 6 months ago for $15/share have a total basis of $3,000. Therefore, the basis of the former shares accounts for 2/3 (*i.e.,* 6000/9,000) of the overall basis, whereas the basis of latter accounts for 1/3 (*i.e.,* 3,000/9,000).

improvement over current law from an economic perspective, there are serious questions about whether this improvement is significant enough to justify the difficulties inherent in adopting a single approach applied across all accounts.

If an average basis system is adopted, we recommend that special rules be adopted in several situations. Treasury should have the power to address multiple basis situations like those raised by shares acquired by gift, and to address other complex basis situations like those raised by the PFIC rules, the wash sale rules, the net investment income rules of section 1411 and transfers between different financial institutions. If a security is held as part of a mixed straddle and therefore becomes subject to mark-to-market taxation, rules will be needed to address how any mark-to-market gain or loss on that security may affect the basis of other identical securities held by the taxpayer.

2. *First in, First out Method*

FIFO has a very significant advantage over other basis determination methods, which is simply that it is the default rule of current law. Consequently, it is well understood and systems are programmed to deal with it. It is straightforward to apply holding period rules to a FIFO system. FIFO also avoids many of the complexities addressed above.

Another advantage of FIFO is that it is relatively simple to administer and that brokers' systems are already programmed to provide the information it requires. As noted above, administrability is a critical consideration in determining the basis of securities, given that those rules affect millions of taxpayers and that in practice the government must largely rely on broker reporting and taxpayer self-reporting. Because the justification for FIFO is based on history and administrative convenience rather than an attempt to measure a taxpayer's true income, it is also easier to reconcile the use of FIFO with an account-by-account approach. Indeed, in order to maximize administrability, account-by-account determinations would be necessary. If FIFO is adopted, we would recommend that all accounts at a single broker held by a taxpayer be aggregated for this purpose, other than accounts managed by an independent asset manager.

On a more theoretical level, FIFO could be considered justifiable as a form of rough justice. While it tends to increase the amount of a taxpayer's gain in a rising market, it also maximizes the likelihood that the taxpayer's holding period will be long-term. Moreover, a realization method of accounting gives taxpayers the benefit of deferring tax on growing wealth. A FIFO basis system terminates that benefit, for the securities that have enjoyed it for the longest period of time. However, FIFO does not reflect economic reality, and because taxpayers make investments in the hope that they will increase in value, they may be more likely to view FIFO as maximizing the amount of gain they realize.

The principal disadvantage of FIFO is that it bears no relationship to a taxpayer's economic gain or loss, at least for shares with the same holding period, because there is no economic difference between selling shares purchased 2 years ago and selling shares purchased 10 years ago. We question whether it is good tax policy to change current law for the determination of basis, which is part of the fundamental architecture of the taxation of securities, to a system that does not more clearly reflect income.

More troublingly, a taxpayer could use the separate account approach of a FIFO rule to avoid the rule altogether. Assume, for example, that a taxpayer holds in a single account 100 shares each of 2-year stock, 5-year stock and 10-year stock, each with a different basis. If the taxpayer sells 100 shares from this account, it will be treated as 10-year stock. If the taxpayer wishes to use a different basis for the sale, and plans sufficiently far in advance, the taxpayer conceivably could transfer whatever proportion of the different lots of shares he or she desires to a new account at a different broker, and sell them after an adequate period of time has elapsed. Alternatively, the taxpayer could move some of the shares to a new account, or an account held by an entity controlled by the taxpayer or a family member, and then sell the shares in the old account. It would be difficult to police transactions of this kind.

The benefits of mandating FIFO are thus that it is well-known; is administrable; arguably is an appropriate realization method; and reduces somewhat the level of electivity in current law. In practice, however, as discussed above, an account-by-account method in practice allows well-advised taxpayers to retain much of the electivity of current law. Accordingly, in our view, FIFO on an account-by-account basis does not constitute a significant enough improvement over current law to mandate changing current law.

3. *Current Law*

The advantages and disadvantages of current law compared to a single method for determining the basis of securities have already been discussed above. Fundamentally, the question is whether the current system is "broken," and if so whether any of the alternatives available are on balance preferable. For the reasons described above, we do not think that the case for changing current law is compelling in light of the concerns that any alternative raises. If a change is made, however, we believe that the average basis method is the better alternative since it is the best measure of a taxpayer's economic gain or loss.

V. **Wash Sales**

Section 422 of the Discussion Draft would amend the wash sale rules of section 1091 to apply to transactions in which a taxpayer sells stock or securities at a loss, and either the taxpayer or a related party acquires substantially identical property or a contract or option to acquire such property. That is, the Discussion Draft expands the wash sale rules explicitly to address transactions in which replacement property is acquired by a related party rather than by the taxpayer.[97] For this purpose, a "related party" includes the taxpayer's spouse or dependent, any entity or person that controls or is controlled by the taxpayer, and a long list of retirement accounts and plans if they are controlled by the taxpayer or a related party, or the taxpayer or a related party is a beneficiary thereof. The Discussion Draft also provides that in the case where a related party, other than the taxpayer's spouse, acquires the replacement property, the loss on the sold stock or securities is disallowed, rather than deferred as is usually the case under the wash sale rules.

[97] The IRS has adopted a similar position in Revenue Ruling 2008-5, 2008-1 C.B. 271, where it concluded that a sale of stock by the taxpayer followed by a repurchase of identical stock by the taxpayer's individual retirement account constituted an acquisition of the stock by the taxpayer for purposes of section 1091.

We support the expansion of the wash sale rules to transactions involving related parties. Transactions of this kind raise issues similar to those addressed by sections 267 and 707, and by the consolidated return rules, albeit in transactions that are not treated as sales by a taxpayer to a related person. One way to frame this in wash sale terms is that if the taxpayer sells property and as part of the same transaction a related party acquires the same property, it is likely that the taxpayer could at a later date reverse the transaction and reacquire the property. That is, expanding the wash sale rules to these transactions in effect treats the taxpayer as if it had an option to reacquire the property.

We observe, however, that a sale of this kind may have real-world consequences that are different from the fact patterns to which the existing wash sale rules apply. For example, if a taxpayer sells loss property and a related party that is owned in part by third parties acquires the property, those third parties are from that point forward exposed to the risks and rewards of that property. This would also be true if the taxpayer sold the property to the related party in a transaction to which section 267 or 707 applied, and so we do not consider it a reason not to expand the scope of the wash sale rules. It is relevant, however, to the question of whether loss on the sale should be automatically disallowed, which is a result harsher than that which applies under the other anti-abuse rules discussed above.

We do not believe that it is necessary or appropriate to apply a harsher rule to a wash sale involving related parties than to a sale between those same parties. Accordingly, we have considered two alternatives for mitigating the loss disallowance rule.

One would extend the current rules of section 1091(d) to the related party purchaser. Those rules provide that the basis of replacement property is equal to the basis of the sold property, adjusted to reflect any difference between the sale price and the repurchase price. For example, under current law, if a taxpayer sells for $90 stock with a basis of $100, and repurchases it for $92, the adjusted basis of the replacement stock is $102 (=$100 + ($92 - $90)). The repurchased property thus has the same $10 built-in loss that the original property had.

Extending this rule to a related party purchaser would mean that the built-in loss in the sold property would become a built-in loss on the property held by the related party. A rule of this kind has certain advantages, notably that it is relatively easy to apply and that the adjustment takes place at the time of the transaction, without the need to track the loss on a going-forward basis. However, we believe that this approach is not desirable, because of the potential for abuse arising from a rule that shifts built-in losses between related parties. It is also not feasible to apply a rule of this kind to property acquired by retirement plans and accounts, because the tax treatment of distributions from such plans and accounts generally is not determined by reference to basis.

The alternative rule we considered would suspend the loss until the property is finally disposed of or the related party ceases to be related. Sections 267 and 707 provide one model for such a rule. The intercompany transaction rules promulgated under section 1502 provide another model. We recommend that the latter be used as a model for developing modified loss deferral rules for wash sale purposes. Under this approach, the $10 loss in the example above would not be deductible until either the related party disposed of the stock or the related party ceased to be related. At that time, the original taxpayer would be entitled to the loss, subject to the limitations that otherwise apply to losses. The taxpayer would have the burden of proving that the conditions necessary to terminate the suspension had taken place. Unlike sections 267 and 707, the loss deduction would not be limited to subsequent gain on the position.

The principal difficulty with this approach is that it requires that the taxpayer be able to track the existence of the suspended loss, perhaps for many years, and that the taxpayer have the necessary information about the actions of the related party. The Discussion Draft addresses one concern about information by providing that married individuals who file separate returns and live separately are not treated as married for this purpose. Similar issues may arise in other personal relationships, for example where a former spouse has sole custody of a dependent child that acquired property contemporaneously with a sale by the taxpayer of identical property, and the former spouses are not on speaking terms. We recommend that Treasury be given authority to address other fact patterns where a taxpayer no longer has access to information about whether a related party continues to own acquired securities. We also recommend that Treasury be given authority to apply the wash sale rules to securities acquired by related persons other than those addressed in the proposal, for example a parent and an adult child, where the purchase and sale are part of a single transaction or related transactions.

Finally, we recommend that the expanded wash sale rules not apply to losses realized by a dealer in securities in the ordinary course of its business as a dealer in securities. That is, if A is a dealer in securities that regularly buys and sells debt instruments issued by X, and A sells X securities at a loss as part of the ordinary course of its business and related party B buys those securities as an investment, the wash sale rules should not apply to A's loss. Rules similar to those that apply under section 108 and subpart F should apply to determine whether A is acting in the ordinary course of a dealer business.[98]

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[98] See Treasury regulation section 1.108-2(e)(2); section 954(c)(2)(C) and Treasury regulation section 1.954-2(a)(4)(iv).