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New York State Bar Association

Tax Section

Report on the Discussion Draft of the Modernization of Derivatives Tax Act of 2016

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New York State Bar Association Tax Section

Report on the Discussion Draft of the Modernization of Derivatives Tax Act of 2016

This report provides observations and recommendations regarding the discussion draft of the Modernization of Derivatives Tax Act of 2016 ("**MODA**"), released by Senator Ron Wyden on May 18, 2016.[1] Similar proposals were contained in the discussion draft of the Tax Reform Act of 2014, introduced on February 21, 2014 by Dave Camp, the former Chairman of the House Ways and Means Committee, and in the General Explanations of the Administration's Fiscal Year Revenue Proposals for fiscal years 2013-2017.[2] We previously commented on the Camp bill and the Administration's proposal.[3]

[1] The principal author of this report is David S. Miller. Comments were received from Michael Farber, Lucy Farr, Malcolm Hochenberg, Robert Kantowitz, Stephen Land, Erika Nijenhuis, David Schizer, and Michael Schler. 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.

The text of MODA, a section-by-section summary, and a Joint Committee on Taxation ("**JCT**") explanation are available at http://www.finance.senate.gov/ranking-members-news/wyden-unveils-tax-proposal-to-build-a-fairer-system (last visited October, 2016).

[2] The discussion draft of the Tax Reform Act of 2014 is referred to as the "**Camp bill.**" The text of the Camp bill 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 October 31, 2016). The General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals, published by the Treasury Department in February 2016, is available at https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf. Similar proposals were made in the Administration's proposals for fiscal years 2016, 2015 and 2014. *See* 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); 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/GeneralExplanations-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, *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf (last visited June 7, 2014).

[3] *See* N. Y. ST. B. ASS'N, TAX SEC., *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* (Rep. No. 1318, Mar. 6, 2015), *available at* https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2015/Tax_Section_Report_1318.html (last visited October 31, 2016) (the "**2015 Report**").

I. SUMMARY OF COMMENTS AND RECOMMENDATIONS

A. Summary of MODA

Very generally, MODA provides that gain or loss with respect to any "derivative" is recognized at the close of any year (*i.e.*, marked to market), and the gain or loss is treated as ordinary gain or loss.[4] Derivative is defined broadly and includes derivatives that are not traded and do not relate to traded property.

If a taxpayer holds an "**underlying investment**" and enters into one or more derivatives that have a delta with respect to any portion of the underlying investment of between –0.7 and –1.0, then the taxpayer is treated as having entered into an investment hedging unit (an "**IHU**") and must recognize built-in gain (but not loss) with respect to the underlying investment, the gain is treated as ordinary gain, thereafter the underlying investment and the derivatives are marked to market, and the straddle rules do not apply to the derivative or underlying investment.

MODA also requires taxpayers to identify each derivative and the underlying investment to which it relates that are not part of an IHU (*i.e.*, the derivative has less of a correlation than a derivative that has a delta relationship with respect to the underlying investment of –0.7). If the taxpayer fails to identify a derivative and the underlying investment to which it relates, then the underlying investment and the derivative are treated as an IHU, and any unrecognized built-in gain with respect to the underlying investment is required to be recognized and treated as ordinary income, and the derivative and underlying investment are required to be marked to market annually.

Finally, taxpayers may elect to treat a derivative and the underlying investment to which it relates as an IHU, recognize built-in gain with respect to the underlying investment, and mark each of them to market annually.

The Camp bill was similar to MODA, except that the Camp bill required unrecognized gain with respect to an investment to be recognized and the investment to be annually marked to marked if the underlying investment and the derivative were part of a straddle; the Camp bill treated the deemed gain with respect to the investment as gain from a sale of the investment; and the Camp bill did not require identification of positions. The Administration's proposal was similar to the Camp bill, except that it applied only to contracts the value of which were determined, directly or indirectly, in whole or in part, by the value of actively traded property.

[4] All references to section numbers are to MODA, or to the Internal Revenue Code and its regulations.

B. Comments and Recommendations

On balance, we continue to believe (as we did in 2015) that a mark-to-market regime for derivatives, such as MODA, could be a substantial improvement over current law, so long as (a) the regime is limited to actively traded derivatives and derivatives with respect to actively traded property and (b) the regime provides workable rules for straddles in which a derivative hedges underlying property. We make a number of recommendations and suggestions to MODA to achieve these objectives. Because a number of our recommendations and suggestions are interdependent and would apply only if all of them are adopted, we first describe how MODA would work if our recommendations are adopted in whole. Then we list each of our recommendations separately.

1. Overview of Our Proposed Regime

Subject to certain limitations described in the 2015 Report, taxpayers would be permitted to elect to mark to market underlying investments that are actively traded. (Unless otherwise indicated, when we refer to "underlying investments," we mean only underlying investments that are actively traded.)

Subject to certain very specific exceptions, all derivatives that are actively traded or relate to actively traded property would be marked to market annually. Derivatives that are not actively traded would not be marked to market. (Unless otherwise indicated, when we refer to "derivatives", we mean only those derivatives that would be marked to market under our regime.)

If a taxpayer owns an underlying investment and enters into one or more offsetting derivatives that relate to the underlying investment and the derivatives have an inverse correlation with the underlying investment of between delta –0.8 to –1.0 (or the substantial equivalent), then any built-in gain with respect to the underlying investment would be deemed to be recognized as if the underlying investment were sold. Built-in loss would not be recognized. This rule would replace section 1259 for underlying investments. (We refer to a delta of –0.8 to –1.0 as the "**0.8 delta threshold**.") If a taxpayer owns an underlying investment and enters into an offsetting derivative that satisfies the 0.8 delta threshold, then future gain or loss with respect to the underlying investment would be marked to market annually for as long as the 0.8 delta threshold is satisfied.

A straddle would be limited to underlying investments and one or more derivatives that are offsetting positions and have a specified inverse correlation, determined by delta (or the substantial equivalent). We have not done the requisite analysis to determine the proper inverse correlation. We refer to this threshold as the "**straddle delta threshold**." If a position and an un-

derlying investment were insufficiently correlated to satisfy the straddle delta threshold, then the position and the underlying investment would not be positions in a straddle.

If a taxpayer enters into a straddle but does not satisfy the 0.8 delta threshold, (i) the taxpayer would be required to identify the positions that make up the straddle, (ii) future gain or loss with respect to the underlying investment would be marked to market annually for as long as it is a position in a straddle, unless the taxpayer specifically identifies the underlying investment as a "realization investment." In addition, the taxpayer's holding period with respect to an underlying investment that is a position in a straddle would be tolled (but not eliminated) for the period that it is a position in the straddle, and the taxpayer would generally be required to defer recognition of realized loss (including interest that is capitalized under section 263(g)) on the positions in the straddle except to the extent that the amount of the loss exceeds the unrecognized gain with respect to positions in the straddle. However, the taxpayer (i) would be permitted to offset any mark-to-market gains against mark-to-market losses for positions in the same straddle, (ii) would be permitted to deduct net mark-to-market losses to the extent of prior net mark-to-market gains with respect to positions in the same straddle, and (iii) would be permitted to carryforward net mark-to-market losses and use them to offset future net mark-to-market gains with respect to positions in the same straddle. These netting and carryforward provisions would apply only to the extent that the taxpayer properly identifies the positions in the straddle. Failure properly to identify the positions in a straddle would not, however, require the taxpayer to recognize built-in gain with respect to the underlying property. Any built-in gain with respect to an underlying investment that is part of a straddle but that does not satisfy the 0.8 delta threshold, and all built-in loss with respect to an underlying investment, would not be recognized until the underlying investment is sold or exchanged under current federal income tax rules.

Any mark-to-market loss under MODA (whether with respect to a derivative or an underlying investment) would be ordinary loss that is treated as attributable to a trade or business of the taxpayer for purposes of sections 62 (so that it is not an itemized deduction) and section 172(d)(4). (When we refer to mark-to-market gains and losses, we mean those under MODA.) Regulated investment companies would be permitted to carry forward any mark-to-market losses and use them to offset mark-to-market gains. The treatment of mark-to-market gains and losses (apart from character) would generally be the same as if the taxpayer had sold or terminated the underlying investments and derivatives.

Debt instruments that are not convertible or exchangeable and bear interest at a fixed or variable rate within the meaning of section 860G(a)(1)(B)(i) ("**straight debt**") would not be treated as underlying investments, and so built-in gain would not be required to be recognized even if the taxpayer enters into offsetting derivatives that cause the 0.8 delta threshold to be satisfied. Convertible debt instruments would be treated as "contingent payment debt instruments" ("**CPDIs**"). CPDIs would not be treated as derivatives except in two situations. First, if at issu-

ance, the derivative components that relate to actively traded property represent more than 50% of the issue price of the debt instrument, then we recommend that the debt instrument be treated as a derivative for purposes of MODA.

Second, if an instrument provides for an upfront transfer of cash but does not provide for a noncontingent 90% return of the cash, and the instrument contains one or more components that, if separated from the rest of the instrument, relate to actively traded property that would be a derivative that is subject to mark-to-market taxation under MODA then, regardless of whether the instrument is debt or a derivative under common law principles, the instrument would be treated as a derivative for purposes of MODA.

2. General Comments to MODA

1. We continue to believe that MODA should be limited to derivatives that are actively traded or relate to actively traded property.
2. We recommend (as we did in 2015) that investors in actively traded securities and commodities be permitted to elect to mark their positions to market, as is the case today for dealers and traders in securities and commodities. In the 2015 Report, we suggested a number of limitations on this election that were intended to limit cherry-picking and potentially abusive transactions.
3. We recommend that the recognition of built-in gain with respect to underlying investments be limited to those underlying investments that have a delta relationship to a derivative of –0.8 to –1.0, or the substantial equivalent. We also recommend that any built-in gain with respect to the underlying investment be treated the same as if the taxpayer had sold the underlying investment.
4. Under MODA, taxpayers are required to identify their derivatives and underlying investments that are not part of an IHU.[5] If they fail to do so, the underlying investments are deemed to be part of an IHU, built-in gain must be recognized with respect to the underlying investments, and thereafter the underlying investments are marked to market.[6] Taxpayers may voluntarily elect to treat underlying investments as part of an IHU (if they otherwise would not be) and thereafter mark them to market, but built-in-gain must be recognized.[7]

[5] Section 492(c)(1)(2)(A)(ii).

[6] Section 492(b)(3).

[7] Section 492(b)(1).

We recommend, instead, that any taxpayer that enters into a straddle (under our revised definition, described in 8, below) that does not satisfy the 0.8 delta threshold must mark to market all future gain or loss with respect to the underlying investments that are positions in that straddle for as long as the underlying investments remain positions in a straddle, unless the taxpayer specifically identifies the underlying investments as realization investments and elects out of mark-to-market for them. However, we would not require taxpayers whose underlying investments are positions in straddles but do not satisfy the 0.8 delta threshold to recognize built-in-gain with respect to them.

5. We support the treatment of mark-to-market gains and losses as ordinary gains or losses. However, we believe that mark-to-market gains and losses should generally be treated as capital or ordinary gains and losses, depending on the nature of the underlying asset for other purposes, such as determining the source of mark-to-market gains and losses, determining whether mark-to-market gains and losses are "unrelated business taxable income" or qualifying income for purposes of section 7704, and determining whether mark-to-market gain gives rise to effectively connected income,

6. We recommend that mark-to-market losses not be treated as miscellaneous itemized deductions. We also would permit regulated investment companies to carry forward their mark-to-market losses to use against future mark-to-market gains.

7. We recommend that the definition of delta be conformed to the definition in the section 871(m) regulations.

8. We recommend that the definition of an underlying investment with respect to a derivative be modified so that it is, with respect to any derivative, any item (i) which is actively traded, (ii) is described in section 493(a)(1)-(8) (or any item substantially the same as such an item), (iii) relates directly or indirectly to the derivative or to a third item to which the derivative also directly or indirectly relates, and (iv) has a minimum inverse relationship equal to the straddle delta threshold with respect to one or more derivatives entered into by the taxpayer. In addition, we recommend that regulatory authority be granted to modify this definition. Finally, we recommend that the definition of straddle be conformed to this definition (*i.e.*, an underlying investment that does not satisfy the straddle delta threshold would not be a straddle with that derivative).

9. If a taxpayer enters into a straddle but does not satisfy the 0.8 delta threshold, (i) the taxpayer would be required to identify the positions that make up the straddle, (ii) future gain or loss with respect to the underlying investment would be marked to market annually for as long as it is a position in a straddle, unless the taxpayer specifically

identifies the underlying investment as a "realization investment." In addition, the taxpayer's holding period with respect to an underlying investment that is a position in a straddle would be tolled (but not eliminated) for the period that it is a position in the straddle, and the taxpayer would generally be required to defer recognition of realized loss (including interest that is capitalized under section 263(g)) on the positions in the straddle except to the extent that the amount of the loss exceeds the unrecognized gain with respect to positions in the straddle. However, the taxpayer (i) would be permitted to offset any mark-to-market gains against mark-to-market losses for positions in the same straddle, (ii) would be permitted to deduct net mark-to-market losses to the extent of prior net mark-to-market gains with respect to positions in the same straddle, and (iii) would be permitted to carry forward net mark-to-market losses and use them to offset future net mark-to-market gains with respect to positions in the same straddle. These netting and carryforward provisions would apply only to the extent that the taxpayer properly identifies the positions in the straddle. Failure to properly identify the positions in a straddle would not, however, require the taxpayer to recognize built-in gain with respect to the underlying property. Any built-in gain with respect to an underlying investment that is part of a straddle but that does not satisfy the 0.8 delta threshold, and all built-in loss with respect to an underlying investment, would not be recognized until the underlying investment is sold or exchanged under current federal income tax rules. In the 2015 Report, we suggested some identification rules to allow taxpayers to match positions and exclude unidentified underlying investments.

10. We recommend that the definition of a derivative not include merger and acquisition agreements, and nonbusiness or non-investment contracts entered into by individuals. We also continue to recommend that the exclusion of compensatory options from the definition of a derivative be expanded to include other forms of equity-linked compensation.

11. We continue to recommend that securities lending, sale-repurchase and similar financing transactions be excluded from the definition of a derivative unless and until otherwise provided by regulations. Alternatively, the intended treatment of these transactions before regulations are promulgated should be clarified.

12. We recommend treating partnerships as taxpayers for purposes of MODA (so that the partners of a partnership that satisfies the 0.8 delta threshold or the straddle delta threshold would be subject to consequences under MODA regardless of the holdings of the partners outside the partnership). We also recommend limiting the look-through partnership rule to partnerships with respect to which the taxpayer owns (or is treated as owing) at least 10% of the capital, profits, or vote, or a principal purpose

with respect to which is avoidance of MODA. That is, only partners with 10% or more of the capital of a partnership or a principal purpose to avoid MODA would be treated as owning the partnership's positions for purposes of applying MODA to their positions held outside of the partnership. We would also apply the look-through rule to other flow-through entities. Basis would be reduced by cash payments of prior accruals.

13. We suggest two alternative regimes for accounting for non mark-to-market income with respect to a derivative or underlying investment. First, income, deduction, gain, or loss with respect to a derivative or an underlying investment that is marked to market could be reported at the time of accrual, in which case option premium would also be accrued. Under this method, the accrual would be reported before the derivative or underlying investment is marked to market. Adjustments would be made to future gain or loss with respect to the derivative or underlying investment to account for the accrual, and basis would be reduced by cash payments of prior accruals. Alternatively, if a taxpayer has elected mark-to-market treatment for all of its positions, then income with respect to the derivatives and underlying investments would not be accrued. Instead, the mark-to-market value would be adjusted for payments.

14. We continue to recommend that partnership interests that resemble derivatives be treated as derivatives.

15. We would not amend section 475 to remove derivatives (as defined in MODA) from its scope, but we would provide Treasury and the IRS with authority to conform section 475 to MODA where appropriate. We recommend that the term derivative and underlying security in MODA be amended so as not to require the taxpayer to mark to market under MODA any position that is marked-to-marked under section 475.

16. We recommend that section 1234A not be repealed.

17. We continue to recommend that Treasury have authority to treat positions held by 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 application of MODA.

18. We recommend that the definition of applicable financial statement in regulation sections 1.475(a)-4(b) and 1.385-2(d)(1) be conformed with the definition in MODA, or the reasons for the differences be explained.

3. Debt

19. We continue to recommend 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.

20. 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 the embedded derivatives, at least in cases where adequate rules already exist—the CPDI rules, the variable rate debt instrument ("**VRDI**") rules, and other OID rules dealing with contingencies—to address them. If the rules regarding convertible debt are changed, convertible debt should also be treated as a CPDI.

    However, if a debt instrument has derivative components that relate to actively traded property and the value of these components is more than 50% of the issue price of the debt instrument, then we recommend that the debt instrument be treated as a derivative for purposes of MODA. Second, if an instrument provides for an upfront transfer of cash but does not provide for a noncontingent 90% return of the cash and the instrument contains one or more components that, if separated from the rest of the instrument, relate to actively traded property that would be a derivative that is subject to mark-to-market taxation under MODA, then we recommend that, regardless of whether the instrument is debt or a derivative under common law principles, the instrument be treated as a derivative for purposes of MODA.

4. Response to Request to Comments

21. We recommend that section 475 and sections 1.1221-2 and 1.446-3 not be integrated into MODA.

22. We believe that MODA could require dealers to provide valuations to their counterparties on derivatives, and to their customers for derivatives and underlying investments that they hold on behalf of their clients. Requiring brokers to keep track of pre-mark-to-market gain and holding period would also be helpful for unsophisticated taxpayers. However, sophisticated taxpayers may not need reporting of pre-mark-to-market gain and holding period.

II. DESCRIPTION OF MODA

A. In General

1. Mark-to-Market Regime for Derivatives

MODA would enact sections 491–493. Very generally under MODA, if a taxpayer has entered into a "derivative" that is not part of an "investment hedging unit" (as described below), whenever the derivative is terminated or transferred, and at the close of each taxable year, the taxpayer is treated as having a "taxable event", is required to recognize ordinary gain or loss, and an adjustment is made to subsequent gain or loss to take into account the gain or loss that is recognized.[8]

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 investments: 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.[9]

[8] *See* section 491(c)(1) (taxable event with respect to a derivative that is not part of an "investment hedging unit"); section 491(a) (gain recognized with respect to a taxable event); section 491(b)(1) (gain is ordinary).

[9] Section 493(a) (definition of a derivative).

A derivative does not include (i) any contract with respect to interests in real property (as defined in section 856(c)(5)(C)) if the contract requires physical delivery of the real estate, (ii) any hedging transaction within the meaning of section 1221(b) or section 988(d)(1), (iii) to the extent provided by the Secretary, the right to the return of the same or substantially identical securities transferred in a securities lending transaction, sale-repurchase transaction, or similar financing transaction, (iv) options described in section 83(e)(3) received in connection with the performance of services, (v) an insurance, annuity or endowment contract issued by an insurance company to which subchapter L applies (or by any foreign corporation to which subchapter L would applied if the foreign corporation were a domestic corporation, (vi) a derivative with respect to stock issued by a member of the same worldwide affiliated group (as defined in section 864(f)) in which one taxpayer is a member, or (vii) any contract with respect to a commodity if (1) the contract requires physical delivery with the option of cash settlement only in unusual and exceptional circumstances and (2) the commodity is used (and is used in quantities to which the derivative relates) in the normal course of the taxpayer's trade or business (or, in the case of an individual, for personal consumption). Section 493(b) (exceptions to derivative).

For purposes of clause (i), a contract that provides for an option of cash settlement is not treated as requiring physical delivery of real property unless the option is (i) not exercisable unconditionally and (ii) exercisable only in unusual and exceptional circumstances. A contract provides an option of cash settlement if the contract settles in (or could be settled in) cash or property other than the underlying real property. Section 493(b)(1)(B).

2. Mark-to-Market Regime for IHUs

If a taxpayer holds an "underlying investment" and one or more derivatives that, by itself or in combination with one or more other derivatives, has a delta with respect to the underlying investment of between –0.7 and –1.0, then the taxpayer is treated as having entered into an "investment hedging unit" (an "**IHU**").[10] Upon the establishment of an IHU, only built-in gain (but not built-in loss) is recognized with respect to the derivative or underlying investment.[11] Thereafter, for as long as the IHU remains an IHU (*i.e.*, the positions satisfy the delta test),[12] the taxpayer is treated as having a taxable event with respect to the IHU (i) at the close of each taxable year, (ii) upon the termination or transfer of the derivative,[13] (iii) the sale or exchange of all or any portion of the underlying investment, and (iv) the entering into of another derivative, or the acquisition of an additional amount of the underling investment that is treated as part of the IHU.[14]

3. Determining Gain or Loss under the Mark-to-Market Regimes

If a taxable event involves the termination or transfer of a derivative or the sale or exchange of an underlying investment, the amount of gain is determined under general federal income tax principles.[15] Otherwise (*i.e.*, in the event a position is marked to market), the gain or

[10] Section 492(a)(1). An underlying investment is any investment described in the prior paragraph and by reference to which the value of the derivative is determined either directly or indirectly. Section 492(e)(1)(A).

Delta is defined as "the ratio of the expected change in the fair market value of the derivative to any change in the fair market value of the underlying investment." It must be determined in a commercially reasonable manner and, except as provided by the Secretary, in the manner used by the taxpayer or the taxpayer's broker for purposes of the "applicable financial statement" described below. Section 492(d).

If the value of a derivative is determined by reference to more than one underlying investment, the delta is determined separately with respect to each underlying investment. Section 492(d)(4).

[11] Section 491(c)(2)(A) (taxable event includes establishment of an IHU); section 491(b)(3) (built-in loss not recognized).

[12] Technically, the taxpayer is treated as having an IHU with respect to an underlying investment during any "applicable hedging period" with respect to the underlying investment. An applicable hedging period is the continuous period beginning with the first time the taxpayer holds one or more derivatives with respect to the underlying investment and one or more portions of the underlying investment that satisfy the delta test and ending with the time none of the derivatives and portions are so described. Section 492(a)(1) and (a)(2).

[13] Termination or transfer includes any termination or transfer by offsetting, by taking or making delivery, by exercise or being exercised, by assignment or being assigned, by lapse, by sale or other disposition, by assumption or otherwise. Section 491(c)(3).

[14] Section 491(c)(2)(A)-(D).

[15] Section 491(b)(2)(A).

loss is equal to the gain or loss that would have arisen if the position were terminated or transferred at fair market value (in the case of a derivative) or sold or exchanged at its fair market value (in the case of an underlying investment).[16] For these purposes, a taxpayer may rely on a valuation that is provided by a broker under section 6045(b), or is determined under an "applicable financial statement."[17] The definition of applicable financial statement is similar to the defi-definitions in regulation section 1.475(a)-4(h) and regulation section 1.385-2(d)(1), with certain modifications and additions.[18]

For example, all three provisions give first preference to a financial statement which is certified as being prepared in accordance with generally accepted accounting principles ("**GAAP**") and is filed with the SEC (such as the 10-K or annual statement to shareholders), but MODA and regulations section 1.385-2(d)(1) gives second preference to a GAAP-certified audited financial statement which is used for credit purposes, reporting to shareholders, partners, or other proprietors, or to beneficiaries, or for any other substantial nontax purposes, whereas this is given third preference in regulation section 1.475(a)-4(h).[19]

The third preference under MODA is for a GAAP-certified financial statement that is filed by the taxpayer with any other federal agency for purposes other than federal tax purposes. (This is also the third preference under regulation section 1.385-2(d)(1) but the second preference under regulation section 1.475(a)-4(h).[20])

The fourth preference under MODA is a financial statement made on the basis of international financial reporting standards and that is filed by the taxpayer with an agency of a foreign government that is the equivalent of the U.S. SEC and has reporting standards not less stringent than SEC requirements. (This preference is not in either regulations sections 1.475(a)-4(h) or 1.385-2(d)(1).)

[16] Section 491(b)(2)(A)(ii). First-in, first-out (FIFO) applies to determine which portions of an underlying investment have been sold or exchanged, unless the taxpayer has an election in place to use an average cost basis method for the underlying investment. Section 491(b)(3)(B).

[17] Section 491(b)(2)(B).

[18] Section 491(f).

[19] Treas. Reg. § 1.385-2(d)(1) does not require that the statement be prepared in accordance with GAAP or audited.

[20] Treas. Reg. § 1.385-2(d)(1) does not require that the statement be prepared in accordance with GAAP or audited. Treas. Reg. § 1.385-2(d)(1) also permits the statement to be provided to a state or foreign government agency.

The final preference under MODA is for a financial statement filed by the taxpayer with any other regulatory or governmental body specified by the Secretary. (This preference is not in either regulations sections 1.475(a)-4(h) or 1.385-2(d)(1).)

Taxpayers may elect to treat any underlying investment and all derivatives with respect to the underlying investment as part of an IHU, even if the positions would not otherwise be an IHU (*i.e.*, the delta test is not satisfied).[21] If the taxpayer makes this election, then the IHU is marked to market daily.[22]

Finally, taxpayers must identify the derivatives "with respect to" an underlying investment (and the portions of the underlying investment) that do not satisfy the delta test.[23] If a taxpayer fails to do so, then the taxpayer is deemed to have elected to treat the derivatives and the underlying investment as an IHU, and therefore must recognize built-in gain with respect to the underlying investment, and thereafter mark to market the IHU.[24]

If one or more derivatives and an underlying investment are identified, but the taxpayer improperly identifies them as part of (or not part of) an IHU, the Secretary is given authority to promulgate regulations to properly characterize the income, gain, expense, or loss arising from the derivatives or underlying investment.[25]

4. Character and Source of MODA Gain or Loss

Gain or loss recognized under MODA is treated as ordinary income or loss, is attributable to a trade or business for purposes of section 172(d)(4) (net operating losses), and is sourced by reference to the taxpayer's residence.[26] Thus, apparently, any mark-to-market losses are treated as miscellaneous itemized deductions, are subject to the 2% floor under section 67 and the 3% Pease limitation, and are disallowed under section 491 for purposes of the alternative minimum tax ("**AMT**"). Thus, for individual taxpayers subject to the 2% floor with respect to miscellaneous itemized deductions or the AMT, an increase in value of one derivative and a simultaneous decrease in the value of another derivative could require the taxpayer to report ordinary income with respect to the appreciation, but be denied losses with respect to the depreciation.

21 Section 492(b)(1).

22 Section 491(c)(1)(E)(i).

23 Section 492(c)(2)(B).

24 Section 492(b)(3)(A).

25 Section 492(c)(5).

26 Section 491(b)(1)(A) (character) and (B) (source).

Actual payments on a derivative. Under MODA, except as provided in regulations, income, deduction, gain or loss with respect to a payment on a derivative (other than an option) is taken into account when paid and proper adjustment is made for purposes of determining future gain or loss.[27] There is no indication how option premium is taken into account. Presumably, the premium is deferred. There is also no indication why option premium would be deferred but premium on a prepaid forward contract would be reported. Payments on derivatives are sourced by reference to the residence of the taxpayer, except as provided in section 871(m).[28]

The holding period of an underlying investment is eliminated if it becomes part of an IHU and does not resume until it is no longer part of the IHU.[29]

Attribution and partnership look-thru. Any derivative or underlying investment held by the spouse of the taxpayer or a corporation that files a consolidated return with the taxpayer is treated as held by the taxpayer.[30] If part or all of the income, gain, loss or expense with respect to a derivative or underlying investment held by a partnership, trust or other entity would properly be taken into account by the taxpayer then, except to the extent otherwise provided in regulations, the derivative or underlying investment is treated as held by the taxpayer.[31]

Separation of a contract into components. If a contract has derivative and non-derivative components, the contract is bifurcated and each derivative component is treated as a derivative.[32] However, if the derivative component cannot be separately valued, then the entire contract is treated as a derivative.[33] A debt instrument is not treated as having a derivative component merely because the debt instrument is denominated in a nonfunctional currency or payments with respect to the debt instrument are determined by reference to the value or a nonfunctional currency.[34] However, convertible debt is bifurcated.

[27] Section 491(d). A payment on a derivative does not include a payment in connection with a taxable event. *Id.*

[28] Section 491(d)(2).

[29] Section 491(e).

[30] Section 492(e)(3)(A); *see* section 1092(d)(4)(B).

[31] Section 492(e)(3)(B).

[32] Section 493(c)(1).

[33] Id.

[34] Section 493(c)(2). Also, except as otherwise provided by the Secretary, American depository receipts (and similar instruments) with respect to shares of stock in foreign corporations are treated as shares of stock in the foreign corporation. Section 493(d).

Repeal of various sections. MODA would repeal sections 1233, 1234, 1234A, 1234B, 1236, 1256, 1258, 1259, and 1260.[35]

Ordinary income treatment for debt instruments held by applicable insurance companies. Finally, MODA would also exclude debt instruments held by "applicable insurance companies" from the definition of capital assets.[36]

B. Comparison of MODA with the Camp Bill and the Administration's Proposal

The most significant difference between MODA and the Camp bill is that the Camp bill required any built-in gain with respect to an investment to be recognized and the investment to thereafter be marked to market if the investment was a position in a straddle with the derivative. MODA limits this treatment to underlying investments that satisfy the 0.8 delta threshold. However, MODA adds an identification requirement for derivatives "with respect to" an underlying investment.

The definition of derivative is generally the same as in the Camp bill. Certain real property is excluded in each, but the definitions vary. Under MODA, a derivative does not include any contract with respect to interests in real property (as defined in section 856(c)(5)(C)), but only if the contract requires physical delivery. The Camp bill excluded a tract of real property (as defined in section 1237(c)) or any real property which would be property described in section 1221(a)(1) with respect to the taxpayer if held directly, but it did not matter if the contract was cash-settled.

The mechanism for marking to market derivatives and underlying investments is different in MODA than under the Camp bill. Under the Camp bill, the derivative and underlying investment were treated as sold, and only gain or loss with respect to the derivative (and not the underlying investment) was automatically treated as ordinary gain or loss. Under MODA, the derivative and underlying investment are not treated as sold; instead gain or loss is recognized and taken into account in the taxable year in which the "taxable event" occurs. All gain or loss under MODA is ordinary.

The Camp bill provided exceptions for straight debt, and for straddles where all of the offsetting positions consisted of stock and qualified covered calls. MODA does not contain those exceptions.

The Camp bill did not permit taxpayers to rely on valuations provided by dealers, or on applicable financial statements. MODA does.

[35] MODA, section 4(a)(1).

[36] MODA, section 3(c).

The Camp bill did not provide for bifurcation of convertible debt instruments, CPDIs, or VRDIs, but provided that regulations could provide that convertible debt instruments be treated as CPDIs. MODA requires bifurcation of convertible debt instruments and CPDIs. It is not clear whether MODA requires bifurcation of VRDIs.

The Camp bill permitted certain hedges for financial accounting purposes to be treated as hedging transactions under section 1221(b). MODA does not contain that provision.

III. Discussion

A. Comments on a Mark-to-Market Regime Generally; Limitation to Derivatives That Are Actively Traded or Relate to Actively Traded Property; Tax Rate of Mark-to-Market Gains.

In the 2015 Report, we listed the possible benefits and detriments of a mark-to-market regime for derivatives and concluded that, on balance, a mark-to-market regime for derivatives could be a substantial improvement over current law. However, we identified two conditions that would have to be satisfied before we could endorse a specific regime.

First, we believed that a mark-to-market regime should be limited to actively-traded derivatives and derivatives with respect to actively-traded property or positions. Second, we believed that workable rules should be provided for transactions in which a non-derivative hedges or is hedged by one or more derivatives.

We continued to believe in the importance of these conditions. MODA does not adequately address either. We address the first one here and the second in Part III.D., below.

We continue to believe that, to avoid intractable valuation and liquidity issues, only derivatives that are actively traded or relate to actively traded property, and underlying investments that are actively traded, should be annually marked to market.

Example One: Two individuals are equal partners in a partnership that owns a bodega (a small grocery store) in New York City. The partners are offered $10,000 by a prospective purchaser for the option to buy their partnership interests for $2 million at any time in the next five years.

Example Two: Two individuals are partners in a partnership that operates a car dealership. Each individual has the option to buy out his or her partner for a stated multiple of earnings.

Under MODA, each option is a derivative and would be required to be marked to market each year.[37] In addition, if either option has a delta of between –0.7 and –1.0 with respect to the partnership interests, the partners would be required to recognize any built-in gain with respect to their partnership interests and would be required to mark to market their partnership interests each year thereafter.

Because the partnership interests in these examples are unique (and not traded), we do not believe that there is any reliable way to determine the value of the option or the partnership interests, or to determine the delta between them. Accordingly, it would be in the interest of the issuer of each option to take the position that the delta of the option is more than –0.7 (so that built-in gain is not recognized), and take the position that in each year, the value of the option increases (so that he or she may claim the loss), and it would be in the interest of the holder of each of the options to claim that the value of the option declines each year (so that he or she may also claim a loss).

We do not believe that the IRS has the resources to litigate these valuation disputes. We also do not believe that a consistency requirement would address the issue. If the buyer of an option were foreign or otherwise tax indifferent (*e.g.*, has extensive NOLs), then both parties would agree to take the position that the option increases in value each year.

Section 493(b)(1) excepts certain real property from the definition of derivative but only if the contract requires physical delivery of the real property. We considered whether a similar rule could exclude non-actively traded derivatives only if they require physical delivery. However, this would not address our concerns that non-traded cash settled options cannot be readily valued. In addition, we are concerned that this exception would merely provide taxpayers with an election to mark to market or not, depending upon whether they provide for a cash settlement option.

We acknowledge that requiring derivatives to be actively traded or relate to actively traded property requires line drawing. In the 2015 Report, we suggested some of these lines.[38]

In the 2015 Report, we discussed whether mark-to-market gains should be taxable at ordinary income rates or preferential capital gains rates, and some technical issues if they are taxable at preferential rates. For purposes of this report, we assume that mark-to-market gains and losses are taxable as ordinary gains and losses.[39]

[37] See section 493(a)(2) (an option to purchase a beneficial interest in a partnership is a derivative); section 491(a) (mark-to-market).

[38] 2015 Report at 42.

[39] 2015 Report at 50.

B. Mark-to-Market Election

We continue to recommend that all taxpayers be permitted voluntarily to mark to market their actively traded securities and commodities. We note that MODA goes far towards permitting this, although we are not sure whether it was intentional.

MODA permits a taxpayer to elect with respect to any underlying investment to treat all derivatives with respect to the underlying investment, and all of the underlying investment, as part of an IHU, which is marked to market.[40]

As a result, a taxpayer who wishes to buy 100 shares of IBM stock and mark them to market could buy 101 shares of IBM stock, and short one share of IBM stock, and apparently elect to treat the 101 shares and one short sale as an IHU, and mark to market the IHU. We do not believe that this result is inappropriate as a policy matter, but are unsure whether it was intended and would prefer that MODA expressly allow an election to mark to market actively traded securities voluntarily.

In the 2015 Report, we suggested that an investor election to mark assets to market be crafted in a way that limits potential for abuse, and we suggested some rules in order to prevent cherry-picking.[41] In addition, we noted that a substantial minority of the Executive Committee was concerned about the ability to select mark-to-market for one asset class but not another but that a majority of the Executive Committee did not share this concern.[42]

C. Narrow the Definition of a Mandatory IHU; Treat the Character of Gain as if the Underlying Investment Were Sold

Under section 492(a), a taxpayer is deemed to enter into an IHU if it holds a derivative with respect to an underlying investment that by itself or in combination with one or more other derivatives has a delta with respect to any portion of the underlying investment of between –0.7 and –1.0. If a taxpayer has entered into an IHU, it must recognize any built-in gain with respect to the underlying investment and mark to market the underlying investment thereafter.

We recommend that the delta test be modified to between –0.8 and –1.0, or the substantial equivalent.[43]

[40] Section 492(b).

[41] 2015 Report at 38-39.

[42] *Id.* at 39.

[43] As Treas. Reg. § 1.871-15 acknowledges, a delta test is difficult to apply to complex contracts. Therefore, we recommend a "substantial equivalence" test for complex contracts. *See* Temp. Treas. Reg. § 1.871-15T(h).

Section 1259 reflects the principle that a taxpayer that has eliminated substantially all of the economic benefits and burdens with respect to appreciated property through derivatives has achieved a result that is economically very similar to a sale of the appreciated property, and should be treated for tax purposes as if the underlying property were sold and the gain recognized. Section 871(m) reflects the analogous principle that a foreign taxpayer that has used derivatives to achieve substantially all of the economic benefits and burdens with respect to stock should not be able to avoid the withholding tax on dividends that would apply to the owner of the stock. The recently promulgated section 871(m) regulations use 0.8 delta as a proxy for ownership and a similar test has been suggested for section 1259.[44]

However, hedges with a delta of between –0.8 and –0.7 are not economically similar to a sale. We are concerned that if MODA requires built-in gain recognition for situations that are not the substantial equivalent of a sale, it would distort market decisions and discourage taxpayers from hedging their property. For this reason we recommend changing the delta requirement for an IHU to –0.8 to –1.0, which we refer to as the "0.8 delta threshold."

If section 1259 applies to a taxpayer, the taxpayer is deemed to have sold his or her appreciated position (and therefore recognizes capital gain or loss if the underlying position is a capital asset). We believe that this treatment is appropriate. In contrast, MODA treats any gain as ordinary. We are concerned that treating built-in gain as ordinary merely punishes the taxpayer for using derivatives to achieve a sale and would discourage their use. We see no reason to do this. Therefore, we recommend that the built-in gain recognized with respect to an underlying investment when it becomes part of an IHU be treated the same as if the taxpayer had sold the underlying investment.

D. Reversal of the Default for Marking-to-Market Underlying Investments; Eliminating the Requirement of Built-In Gain Recognition

MODA requires taxpayers to identify their derivatives and underlying investments that are not part of an IHU;[45] and if they fail to do so, the underlying investments are deemed to be part of an IHU, built-in gain must be recognized and, thereafter, the underlying investment must be marked to market.[46] However, taxpayers may elect to treat underlying investments that are not part of an IHU (*i.e.*, they do not satisfy the –0.7 delta relationship), as part of an IHU and then

[44] Treas. Reg. § 1.871-15(d)(2)(i); see Thomas J. Brennan, *Law and Finance: The Case of Constructive Sales* (Sept. 9, 2013) (ANN. REV. OF FIN. ECON., forthcoming), *available at* SSRN (analyzing delta of the variable prepaid forward contract described in Revenue Ruling 2003-7 and concluding in a non-dividend case, the maximum delta value of the contract would be not much greater than 0.8).

[45] Section 492(c)(1)(2)(A)(ii).

[46] Section 492(b)(1).

voluntarily mark them to market, in which case built-in gain must be recognized with respect to the underlying investment.

Thus, under MODA, in the absence of a –0.7 delta relationship, the default rule is that the underlying investment is subject to realization-based taxation (rather than mark-to-market); however, if the taxpayer fails to properly identify the underlying investment, or specifically elects mark-to-market treatment, the taxpayer must recognize any built-in gain.

We would reverse the default rule in MODA so that any underlying investment that is a position in a straddle with a derivative must be marked to market annually, unless the taxpayer specifically identifies the underlying investment and elects to treat it as subject to realization taxation. This election would be available only for underlying investments that do not satisfy the 0.8 delta threshold.

We would do so because we believe that most taxpayers (and especially unsophisticated taxpayers) would want to avoid the timing and character mismatches with respect to hedged positions that arise if one of the positions (*i.e.*, the derivative) is marked to market (and gains and losses are ordinary) and the other (*i.e.*, the underlying investment) is not marked to market and gains and losses are capital. We also believe that mark-to-market taxation is the most accurate method of tax accounting and permits the least amount of abuse, so the government should also prefer it as the default. However, because we do not want to discourage hedging, because some taxpayers will prefer to remain on the realization system with respect to their underlying investments, and because we believe that the straddle rules (as we would revise them) adequately protect against abuse, we would permit taxpayers to elect to remain on the realization system for their underlying investments that are a position in a straddle (so long as they do not satisfy the 0.8 delta threshold).

Also, for underlying investments that do not satisfy the 0.8 delta threshold, we would not require that built-in gain be recognized until a recognition event occurs under traditional realization rules. We are concerned that if entering into a hedge requires built-in gain acceleration, taxpayers would be inappropriately discouraged from hedging. Therefore, we believe that recognition of built-in gain should be limited to those taxpayers that eliminate substantially all of the benefits and burdens of ownership by satisfying the 0.8 delta threshold.

E. Clarification of the Definition of IHU in the Context of Mismatched Positions

We believe that section 492(a)(1)(B) should be clarified to provide that an IHU consists of the portion of each underlying investment that produces the delta that is closest to -1.0 within the range (-0.7 to -1.0 under MODA as drafted, or -0.8 to -1.0 under our recommendations) with respect to the derivatives that are part of the IHU. Where a taxpayer has shares of stock and shorts a smaller number of shares, this formulation will match shorts and shares. Assume that a

taxpayer holds 100 shares of stock and shorts 80 shares (and has no other assets). We believe that section 492(a)(1)(B) should be applied to treat the IHU as consisting of 80 shares and 80 shorts because 80 shares is the portion of the underlying investment that produces the delta that is closest to -1.0 (it produces a delta that is -1.0) and is within the range. However, we note that 80 shorts have a delta of -0.8 with respect to 100 shares and therefore that section 492(a)(1)(B) could be interpreted to bring all 100 shares into the IHU. We also recognize that if the full 100 shares were part of the IHU in this example, then a taxpayer who has 100 shares and enters into 20 shorts could argue that he or she does not have *any* IHU, because the delta of 100 shares and 20 shorts is only -0.2. If our recommendation is adopted, then, in our first example above, the taxpayer would have an IHU consisting of 80 shares and 80 shorts, and in our second example above, the taxpayer would have an IHU consisting of 20 shares and 20 shorts. It would also be helpful if section 492(b) were clarified to provide that the taxpayer in each example could elect to treat the full 100 shares as part of an IHU, but the full 100 shares would be part of an IHU with the shorts only if the taxpayer so elected under section 492(b). Finally, for a taxpayer that has a mismatched position and does not make the election, MODA should address which of the taxpayer's shares are deemed to be part of the IHU. One possibility would be to require that a percentage of each share be deemed to be part of the IHU (e.g., 80% of each of the 100 shares in the first example above), but we believe the results would be simpler and more intuitive if the taxpayer was permitted to designate the requisite number of whole shares to be deemed part of the IHU.

F. Treatment of Post-Mark-to-Market Gain or Loss

We have considered the treatment of an underlying investment that is subject to mark-to-market treatment (either because it is a position in an IHU or a position in a straddle) and thereafter is no longer subject to mark-to-market treatment (because it is no longer a position in an IHU or a straddle).

As we discussed in the 2015 report,[47] there are two approaches that could be taken. First, one could view the underlying investment that is no longer subject to mark-to-market treatment as a continuation of the underlying investment that was subject to mark-to-market treatment. In this case, the character of the gain or loss from underlying investment after it is no longer subject to mark-to-market treatment would depend upon the gain or loss from some or all of the positions that made up the IHU or straddle. This rule would be designed to avoid timing or character mismatches with respect to the underlying investment. We refer to this as the "continuation approach". This is the rule applied to CPDIs, which treats loss as ordinary to the extent of prior

[47] 2015 Report at 60-61.

ordinary income.[48] It is also consistent with the carryforward of built-in losses on underlying investments that become part of an IHU or straddle, and with our recommendations that (i) derivatives that have a delta of more than -0.8 (i.e., less of an inverse correlation than -0.8 delta implies) not cause realization of built-in gain (and therefore that the built-in gains are preserved through a straddle), and (ii) straddles give rise to a tolling rather than elimination of holding period.

Alternatively, one could view the underlying investment that is no longer subject to mark-to-market treatment as an entirely new investment (i.e., as if all of the positions that made up the IHU or straddle were sold and terminated immediately after they are no longer positions in the IHU or straddle). We call this the "fresh start approach". The fresh start approach is by far the simpler to adopt, which is a significant virtue. As the examples below demonstrate, however, it is more likely to give rise to mismatches in the character of total gain or loss, if one (contrary to the spirit of the fresh start approach) looks at a taxpayer's investment in the stock as a continuous investment through and after the hedging period.

The continuation approach – that is, recharacterizing post-hedge gains or losses as ordinary, in part or whole, to the extent necessary to reverse hedge-period loss or gain – could be carried out either by reference solely to the underlying investment, which we call the "gross" method, or by reference to net gain or loss from all of the positions in the IHU or straddle, which we call the "net" method. Both alternatives are complex to apply, particularly if positions in the IHU or straddle are purchased or sold but IHU or straddle status is maintained, because they require the taxpayer to track hedge-period gain/loss. They also can give rise to non-intuitive results. On balance, we believe that the net method is the better of the two.

Example Three (Net hedge period income, post-hedge loss): A taxpayer buys stock for $100 and enters into a hedge with respect to the stock. The stock appreciates to $150 and the hedge drops in value by $40 and then terminates. The taxpayer recognizes $50 of ordinary income and $40 of ordinary loss. The taxpayer does not elect to continue to mark the stock to market. In the following year, the stock falls in value to $125 and the taxpayer sells it. The results under the methods described above are as follows.

Example 3	*Economics*	*Fresh start*	*Continuation – gross*	*Continuation -- net*
Stock – hedge period	+50	50 ordinary gain	50 ordinary gain	50 ordinary gain
Hedge	(40)	40 ordinary loss	40 ordinary loss	40 ordinary loss

[48] *See* Treas. Reg. § 1.1275-4(b)(6).

Stock – post hedge	(25)	25 capital loss	25 ordinary loss (because stock had 50 ordinary gain)	10 ordinary loss (because net hedge period ordinary gain is 10), 15 capital loss
Net aggregate gain/loss	**(15)**	**10 ordinary gain, 25 capital loss**	**15 ordinary loss (taxpayer's net loss on the stock is treated as ordinary loss)**	**15 capital loss**

Example Four (Net hedge period loss, attributable to the hedge): A taxpayer buys stock for $100, and buys an at-the-money put option to protect against the risk of loss on the stock. The put option does not satisfy the 0.8 delta threshold, but is a straddle with respect to the stock, and (under our proposal) the taxpayer marks to market both positions. The stock does not change in value and the put expires. The taxpayer recognizes no mark-to-market ordinary income on the stock and a $10 ordinary loss with respect to the put. The taxpayer does not elect to continue to mark the stock to market. In the following year, the stock rises in value to $110 and the taxpayer sells it. The results under the methods described above are as follows.

	Economics	*Fresh start*	*Continuation – gross*	*Continuation -- net*
Stock – hedge period	0	0	0	0
Hedge	(10)	10 ordinary loss	10 ordinary loss	10 ordinary loss
Stock – post hedge	+10	10 capital gain	10 capital gain	10 ordinary gain
Net aggregate gain/loss	**0**	**10 ordinary loss, 10 capital gain**	**10 ordinary loss, 10 capital gain**	**Net 0 ordinary gain/loss (the loss on the hedge effectively transforms the post-hedge stock gain into ordinary gain)**

Additional rules could be added to modify the results under the continuation approach, if desired, for example, providing that the continuation net method applies only to the extent of gain or loss recognized with respect to the underlying investment during the hedge period.

There are additional concerns that should also be addressed. One is whether a taxpayer can change the results described above if it sells the stock at the close of the hedge period, and then reacquires it. That would not affect the results of the fresh start approach, because it effectively deems the taxpayer to do just that for character purposes, although an actual sale would presumably trigger any built-in gain or loss and restart any holding period the taxpayer had. For continuation method purposes, however, an actual sale would eliminate the future matching of character.

For example, assume that the underlying investment that is a position in a straddle depreciates and there is net loss on the straddle positions when the derivatives are terminated. Under the continuation approach, if the taxpayer holds the underlying investment, future gain would be treated as ordinary income to the extent of the (net) ordinary loss from the hedge period, while future loss on the underlying investment would be treated as capital loss. Assume instead that the taxpayer sells the underlying investment (for no gain or loss) and immediately thereafter repurchases the underlying investment. If the sale and repurchase are respected, the taxpayer could avoid ordinary treatment on future gain, without any adverse consequences if there is future loss. Likely rules similar to the wash sale rules would have to be adopted to deem any underlying investments that are purchased within 30 days of the termination of an IHU or a straddle with net loss to be continuations of the underlying investments that were part of the IHU or straddle. Consideration would also have to be given as to whether a similar approach should be applied to underlying investments that relate to a straddle with net gain.

Finally, all of the discussion above has assumed that the underlying investment had no built-in gain or loss that was suspended when the hedge was entered into. The results above would change if the stock had unaccelerated built-in gain or loss. While we have not fully explored the issues, it seems likely that recognizing built-in gain or loss on a post-hedge disposition of the underlying investment would increase the number of outcomes that would give rise to aggregate ordinary income and capital loss (or the reverse), and taking the built-in gain or loss into account will undoubtedly increase the complexity of the system.

G. Basis

Mark-to-market gain under MODA does not affect basis. Instead, proper adjustment is made with respect to future gain or loss.

As we pointed out in the 2015 Report, the absence of basis adjustments to account for mark-to-market gains and losses presents issues about the treatment of a mark-to-market underlying investment that has changed in value (and with respect to which mark-to-market gain or loss was recognized) and is contributed to or distributed from a partnership or corporation, sold

to a related party in a transaction described in section 267(a), and other similar situations.[49] Also, basis is relevant in other contexts, such as for purposes of section 108(b)(2)(E). Adjusting the basis of an underlying investment to reflect mark-to-market gain or loss would address many of these issues and questions. Thought should also be given whether derivatives with negative value will be treated as having "negative basis."[50]

H. Repeal of Section 1256; Sourcing and Character Rules

We continue to support the treatment of mark-to-market gains and losses as ordinary gains and losses. MODA provides that, in the case of a taxable event with respect to a derivative, gain or loss is treated as derived from sources within the country of residence of the taxpayer. However, MODA provides no other guidance with respect to the nature of the mark-to-market gains and losses. For example, are the gains and losses "unrelated business taxable income"? Are the gains "qualifying income" for purposes of the actively traded partnership rules of section 7704? Also, if the underlying investments are capital assets, treating the gains and losses as other than capital gains and losses would subject them to a different set of rules to determine whether they are effectively connected income.[51]

We recommend that mark-to-market gains and losses generally be treated the same as gains and losses from a taxable sale of the underlying investments or a taxable termination of a derivative for these and other purposes, and that derivatives and underlying investments that are capital assets remain capital assets even though they give rise to ordinary income for purposes of MODA.[52] However, we would provide regulatory authority for the IRS and Treasury to designate a different sourcing rule or to treat derivatives and underlying assets as ordinary assets in appropriate situations.

[49] 2015 Report at 62.

[50] *Id.*

[51] *See* Treas. Reg. § 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).

Other examples are described in the 2015 Report at 51.

[52] However, mark-to-market losses would not be subject to the wash sale, straddle, or other anti-abuse rules. *See* 2015 Report at 62.

I. Treatment of Mark-To-Market Losses as Miscellaneous Itemized Deductions; Carryforward of Mark-to-Market Losses for RICs; Period for Carrying Back and Carrying Forward Mark-to-Market Losses

Section 491(b)(1)(A) provides that income, deduction, gain or loss taken into account under section 491(a) with respect to a taxable event is treated as ordinary income or loss that is attributable to a trade or business of the taxpayer for purposes of section 172(d)(4) (relating to net operating losses).

Section 63(d) defines the term "itemized deductions" as all deductions other than those allowable for purposes of determining adjusted gross income. The deductions allowable for purposes of determining adjusted gross income include trade or business deductions and losses from the sale or exchange of property, but do not otherwise include section 491 losses. Section 491(b)(1)(A) treats losses as attributable to a trade or business only for purposes of section 172(d)(4) and not for purposes of section 62(a).

If mark-to-market losses under MODA were miscellaneous itemized deductions, they would be subject to the 2% floor under section 67 and the 3% Pease limitations under section 68, and would be disallowed for alternative minimum tax purposes.[53] We believe that this is inappropriate. The tax policy underlying MODA is economic taxation of income. If economic losses are denied for tax purposes, this tax policy objective would not be accomplished. Moreover, if mark-to-market losses are treated as miscellaneous itemized deductions and denied, MODA would distort market decisions and require taxpayers to assume more risk than they otherwise would. For these reasons, we recommend that losses under section 491(a)(1) be treated as attributable to a trade on business for purposes of section 62 as well as section 172(d)(4).

Section 852(b)(2)(B) provides that RICs are not entitled to the net operating loss deduction provided in section 172. Thus, a RIC that recognizes a mark-to-market loss with respect to a derivative in one year but does not have sufficient gains in that taxable year to offset the loss would never be permitted to use the loss. If the derivative increased in value by the same amount in the subsequent year, the gain would be subject to tax (payable either by the RIC or its shareholders) without offset for the prior loss. We believe that this result is also inconsistent with the principal purpose of MODA: economic taxation of income. To remedy this, we would permit RICs to carryover mark-to-market losses under MODA.

MODA treats income, deduction, gain or loss taken into account under section 491(a) as attributable to a trade or business of the taxpayer for purposes of section 172(d)(4), but is unclear as to the period over which the loss may be carried. Section 172(b)(1) provides that net operating

[53] See section 55 (in position of minimum tax); section 56(b)(1)(A)(i) (denying deduction for miscellaneous itemized deductions.

losses ("**NOLs**") may be carried back two years and forward twenty years. Corporations may carry back net capital losses three years (more than NOLs) and may carry them forward five years (less than NOLs).[54] Individuals cannot carry back their net capital losses (worse than NOLs), but can carry them forward indefinitely (better than NOLs),[55] but individuals can carry back their net section 1256 contract losses for three years.[56] Moreover, the periods have changed independently. For example, before 1997, NOLs were carried back three years and forward fifteen years.

Congress could decide that because taxpayers would not have the ability to cherry-pick their losses under mark-to-market taxation, the treatment of losses should be the same as for NOLs. Alternatively, to the extent that mark-to-market assets are held as passive investment assets, Congress could decide that the treatment of net capital losses provides the most-appropriate analogy.

J. Definition of Delta

Section 492(d)(1) provides that:

The term "delta" means, with respect to any derivative and underlying investment, the ratio of the *expected* change in the fair market value of the derivative to *any* change in the fair market value of the underlying investment (emphasis added).

In contrast, regulation section 1.871-15(g) provides that:

Delta is the ratio of *the change* in the fair market value of an NPC or ELI to *a small change* in the fair market value of the number of shares of the underlying security (as determined under paragraph (j)(3) of this section) referenced by the NPC or ELI (emphasis added).

There are two important differences between these two definitions. First, the MODA definition compares "expected" change in the fair market value of the derivative to "any" change in the fair market value of the underlying investment. Second, regulation section 1.871-15(g) compares "the change" in the fair market value of a derivative to "a small change" in the fair market value of the underlying investment.

We believe that the section 1.871-15(g) test is the better of the two, and that the MODA definition of delta should be conformed to the section 1.871-15(g) definition.

[54] Section 1212(a)(1).

[55] Section 1212(b).

[56] Section 1212(c)(1)(A).

Assume that if the taxpayer buys a share of stock for $100 and buys an out-of-the money put option that permits the taxpayer to sell the share for $90. Assume that if the share were to drop in value by $1, then the value of the option would increase in value by less than 70 cents. If MODA were to contain the 1.871-15(g) test, the 0.7 delta test would not be satisfied. However, the MODA test requires consideration of all possible values of the underlying investment. If the stock were to drop by $99, then the value of the put option would be expected to increase in value by more than $69.30 (.7 x $99). Because the expected increase in the fair market value of the put option upon at least one possible change in the fair market value of the underlying investment exceeds 0.7, it appears that the MODA delta test would be satisfied, but the section 1.871-15(g) test would not be. In fact, the MODA test would seem to provide that the 0.7 delta test is always satisfied. This is inappropriate.

K. Definition of Straddle and Underlying Investment

1. Use of a Delta Test for Straddle and Underlying Investment

We support the use of a delta test to determine a constructive sale. A delta test provides a much more accurate test than the statutory language of section 1259. We believe that a delta test (*i.e.*, the straddle delta threshold) could also be used to measure the requisite correlation for a straddle and provide a much more accurate definition than under current law.

We would also conform the definition of underlying investment with the definition of straddle so that an item that is described in section 493(a)(1)-(8) would not be an underlying investment if it does not satisfy the straddle delta threshold (*i.e.*, it has less inverse correlation with an underlying investment than a position with a delta equal to the straddle delta threshold would have) with respect to each derivative (and combination of derivatives) of the taxpayer.

That is, assume that a taxpayer owns a share of stock and purchases a put option with respect to the share but the correlation between the stock and the put option is less than the straddle delta threshold. We would provide that the put option is marked to market but that the share of stock is not an underlying investment or a straddle with respect to the option, so that the taxpayer would not have to identify the share of stock as a position in a straddle or as an underlying investment with respect to the put option.

Finally, the definition of underlying investment requires that the value of the derivative be determined directly or indirectly with respect to it. We would clarify this definition.

Assume that a taxpayer purchases an S&P 500 ETF and buys a put option with respect to the S&P 500. Although, as a policy matter, the S&P 500 ETF should be an underlying investment with respect to the put, the value of the put arguably is not determined directly or indirectly by the ETF. Instead, the value of each of the put option and the S&P 500 ETF is determined by

reference to the S&P 500. The definition could be clarified by providing in section 492(e)(1)(A)(ii) that an underlying investment also includes any item by reference to which the value of a third item is determined either directly or indirectly if the value of the derivative is also directly or indirectly determined by that third item. In the prior example, the S&P 500 would be that third item. The value of the ETF and the put option would each be determined by reference to it.

In fact, we believe this definition could also be stated in terms of a derivative relating to an underlying investment. When combined with our proposals to limit the definition of underlying investments to actively traded property that has a delta that is less than the straddle delta threshold with respect to the derivative, the definition of underlying investment would read in full as:

> The term 'underlying investment' means, with respect to any derivative, any item that—
>
> (i) is actively traded,
>
> (ii) is described in section 493(a)(1)-(8) (or any item which is substantially the same as such item),
>
> (iii) relates directly or indirectly to one or more derivatives or to a third item to which the derivative or derivatives also directly or indirectly relate, and
>
> (iv) has a delta between the straddle delta threshold and –1.0, or the substantial equivalent, with respect to one or more derivatives entered into by the taxpayer.
>
> We also recommend that regulatory authority be granted to modify this definition.

2. Definition of Offsetting Position

As mentioned above, we believe that the definition of an underlying investment and the definition of a position in a straddle should be conformed so that only investments that are offsetting positions in a straddle are treated as underlying investments.

Section 1092(c)(2)(A) provides that a taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of risk of loss from holding any position with respect to personal property by reason of holding one or more other positions with respect to personal property. However, there is no guidance as to the extent to which the risk of loss in holding positions must be diminished to be deemed substantially diminished. In addition, the only guidance as to whether two indices can be offsetting positions are the mechanical rules in regulations section 1.246-5.

Redefining the definition of offsetting position is beyond the scope of this report. However, in light of the use of delta in MODA, we did consider whether the definition could be stated

solely in terms of delta or correlation. That is, if a taxpayer entered into a long position with respect to one index and a short position with respect to a different index with substantially different positions (so that the substantial overlap test in regulations section 1.246-5 was not satisfied), but the two indices were very highly correlated, would it be appropriate for the taxpayer to be treated as having entered into a straddle?

We cannot recommend such a rule. First, in light of the high correlation of disparate indices, we are concerned that such a rule would produce counterintuitive results and therefore would be a trap for the unwary. For example, the SPDR S&P 500 trust (the ETF trading under the symbol SPY), which trades the S&P 500 stock market index, has a correlation of 0.85 with respect to the Vanguard FTSE All-World ex-US ETF (the ETF trading under the symbol VEU), which tracks the FTSE All-World ex US Index, even though there is no overlap.[57] Second, correlations can change rapidly. On November 7, 2016, the correlation between the financial stocks in the S&P 500 and the S&P 500 itself was 0.89. However, as of November 23, 2016, the correlation had fallen to 0.59.[58]

L. Consequences of Entering into a Straddle

If a taxpayer enters into a straddle but does not satisfy the 0.8 delta threshold, (i) the taxpayer would be required to identify the positions that make up the straddle, (ii) future gain or loss with respect to the underlying investment would be marked to market annually for as long as it is a position in a straddle, unless the taxpayer has specifically identified the underlying investment as a "realization investment." In addition, the taxpayer's holding period with respect to an underlying investment that is a position in a straddle would be tolled (but not eliminated) for the period that it is a position in the straddle, and the taxpayer would generally be required to defer recognition of realized loss (including interest that is capitalized under section 263(g)) on the positions in the straddle except to the extent that the amount of the loss exceeds the unrecognized gain with respect to positions in the straddle, except that the taxpayer (i) would be permitted to offset any mark-to-market gains against mark-to-market losses for positions in the same straddle, (ii) would be permitted to deduct net mark-to-market losses to the extent of prior net mark-to-market gains with respect to positions in the same straddle, and (iii) would be permitted to carry forward net mark-to-market losses and use them to offset future net mark-to-market gains with respect to positions in the same straddle. These netting and carryforward provisions would apply

[57] ETF Correlations with SPY, *available at* http://www.etfscreen.com/corrsym.php?s=SPY (last visited on Nov. 29, 2016).

[58] Gunjan Banerju, *Sectors Go Wild: S&P 500 Correlations Crumble*, WALL ST. J. (Nov. 23, 2016) *available at* http://www.wsj.com/articles/sectors-go-wild-s-p-500-correlations-crumble-1479908402 (last visited on Nov. 23, 2016).

only to the extent that the taxpayer properly identifies the positions in the straddle. Failure properly to identify the positions in a straddle would not, however, require the taxpayer to recognize built-in gain with respect to the underlying property. Any built-in gain with respect to an underlying investment that is part of a straddle but that does not satisfy the 0.8 delta threshold, and all built-in loss with respect to an underlying investment, would not be recognized until the underlying investment is sold or exchanged under current federal income tax rules.

We recommend that all interest be allocated to the underlying investment for purposes of section 263(g). This is a simplifying rule that avoids difficult allocation issues. In its absence we suspect that taxpayers would allocate as much interest as possible to the derivative where, under our proposal, it could be used to offset gains on the derivative.

In the 2015 Report, we suggest some identification rules to allow taxpayers to match positions and exclude unidentified underlying investments.

1. Identification Requirement

MODA requires taxpayers to identify the portions of an underlying investment that satisfy the 0.7 delta test (and therefore constitute an IHU), and the derivatives "with respect to" an underlying investment that do not satisfy the 0.7 delta test.[59] MODA does not explain how to determine which derivatives are "with respect to" an underlying investment. If a taxpayer fails to properly identify underlying investments, then they are deemed to be part of an IHU,[60] built-in gain is deemed to be recognized,[61] and future gains and losses with respect to the underlying investment are subject to daily mark-to-market tax.[62]

We believe that the definition of underlying investment and straddle should be conformed, and that investments with an insufficient inverse correlation (*i.e.*, investments that do not satisfy the straddle delta threshold) with the taxpayer's derivatives should not be treated as underlying investments or positions in a straddle. Second, as mentioned above, we believe that the penalty under MODA for failure to identify an investment as an underlying investment—accelerated recognition of built-in gain—is too harsh. Instead, we recommend that a taxpayer that fails to properly identify the positions in a straddle not be permitted to net mark-to-market losses and gains with respect to the unidentified positions. However, because (notwithstanding the failure to identify the positions) they would still be positions in a straddle, the loss deferral rules would apply and therefore a taxpayer that fails to identify the positions in a straddle would

[59] Section 492(c)(2).

[60] Section 491(b)(3)(A)(ii).

[61] Section 491(c)(2)(A).

[62] Section 491(c)(2)(E).

be required to report mark-to-market gains on the positions, but would be required to defer losses incurred with respect to unidentified positions in the straddle. This timing mismatch would provide a strong incentive for taxpayers to properly identify their positions in straddles.

2. Future Gain or Loss with Respect to the Underlying Investment Should Be Marked to Market Unless the Taxpayer Timely Identifies the Underlying Investment as a Realization Investment

As mentioned above in part III.D., we would reverse the default rule under MODA that treats an underlying investment as subject to realization based taxation unless the taxpayer specifically elects to mark it to market. Instead, we would subject all underlying investments that are positions in a straddle to mark-to-market with respect to gains and losses after the date it becomes a position in a straddle and for as long as it is a position in a straddle, unless the taxpayer specifically elects to treat the underlying investment as a realization investment.

3. Tolling of the Taxpayer's Holding Period if He or She Has Not Accrued a Long-Term Period

Section 491(e) provides that, for purposes of section 1222, for any period that an underlying investment is part of an IHU, the holding period does not include any period during which the underlying investment is part of the IHU or before the date that the underlying investment became part of the IHU. Thus, MODA causes the holding period of an underlying investment to be eliminated when it becomes part of an IHU.

As we recommended in the 2015 Report,[63] we believe that the holding period of an investment that does not satisfy the 0.8 delta threshold but becomes an underlying investment and a position in a straddle should be merely tolled and not eliminated. If the holding period were eliminated upon entering into a straddle that does not satisfy the 0.8 delta threshold, taxpayers will be "locked-out" (or discouraged) from entering into hedges, especially if they have accrued a significant holding period. We recognize that a tolling rule does increase compliance and administrative costs because taxpayers must keep track of pre-straddle holding periods, and the IRS will have to audit these periods, but we believe these costs will be relatively minor.

4. Section 263(g)

The principle underlying our proposed revision to the straddle rules is that taxpayers with built-in gain with respect to their underlying investments should not be permitted to deduct net loss with respect to the positions in the straddle until the net loss exceeds the unrecognized gain.

[63] 2015 Report at 62.

Interest expense described in section 263(g) represents a potential source of loss. We recommend that interest expense that is capitalized under section 263(g) be deferred except to the extent it, along with any other deferred loss, exceeds the unrecognized gain in the positions in the straddle.

5. Loss Deferral, Netting of Mark-to-Market Gains and Losses, Deduction of Losses to the Extent of Prior Net Mark-to-Market Gains, and Carryforward of Mark-to-Market Losses

As mentioned above, the principle underlying our revision to the straddle rules is that, if a taxpayer has built-in gain with respect to an underlying investment (either because it had built-in gain when it became a position in a straddle or the taxpayer elected to treat the underlying investment as a realization investment), net losses with respect to the straddle (including interest expense that is capitalized under section 263(g)) should not be allowed, except to the extent that they exceed the built-in gain.

This principle would allow full netting of mark-to-market losses (which would not include interest expense capitalized under section 263(g)) against mark-to-market gains in any year. It would also permit a deduction for any net mark-to-market losses to the extent of prior net mark-to-market gains, and it would permit an unlimited carryover of losses to be used against future net mark-to-market gains with respect to positions in the same straddle. In Part III.G, we list some alternative carryforward and carryback periods.

6. Rules and Procedures to Determine and Identify Positions in a Straddle

As we discussed in the 2015 Report, we recommended definitive rules for determining when positions are part of a straddle, and identification procedures that allow taxpayers to identify which positions are part of a straddle.[64] We continue to believe that these rules and procedures are necessary.

M. Treatment of Derivatives That Are Indices

Section 492(d)(4) provides that if the value of a derivative is determined by reference to more than one underlying investment, the delta is determined separately with respect to each underlying investment.

This section clearly applies to a taxpayer that has three underlying investments and enters into an offsetting total return swap that provides that the taxpayer pays the appreciation and receives the depreciation with respect to each underlying investment.

[64] 2015 Report at 56-58.

It is less clear whether this section applies to a taxpayer that owns a stock that is a component of the S&P 500 and shorts the S&P 500. If one were to view the value of the S&P 500 as determined by reference to each of the component stocks of the S&P 500, then section 492(d)(4) could apply to require the taxpayer to determine the delta with respect to that single component stock of the index.

We do not think that section 492(d)(4) is properly read to apply to an index that is itself actively traded, and we do not think that section 492(d)(4) should be applied to such an index.

First, under section 493(a)(7), an index itself is a derivative. When an index itself actively trades, its value is its trading price, and that value is not determined by reference to more than one underlying investment (as would be the case if a nontraded total return swap referenced more than one underlying investment).

Second, determining the delta with respect to a single component stock of an actively-traded index would be difficult. Assume that a taxpayer holds Microsoft stock and enters into a "short" forward contract with respect to the S&P 500. The forward contract would not provide dividend equivalents with respect to the components of the index so it would not have a delta of -1.0 with respect to each component. In this case, one would expect that the delta would be higher for stocks that pay consistent dividends and lower for stocks whose dividends are volatile, but the delta would be very difficult to determine with respect to any particular stock.

For these reasons, we do not recommend that section 492(d)(4) apply to an index that is actively traded but if it is intended to require a taxpayer to determine the delta of any single component stock of an actively-traded index, it should provide so explicitly.

N. Exclusion from the Definition of Derivative for Merger and Acquisition Transactions, Nonbusiness or Noninvestment Contracts Entered Into by Individuals and Equity-Linked Compensation

MODA excludes from the definition of derivative any option described in section 83(e)(3) received in connection with the performance of services,[65] and any contract with respect to a commodity if the contract requires physical delivery with the option of cash settlement only in unusual and exceptional circumstances and the commodity is used (and is used in quantities with respect to which the derivative relates) in the normal course of the taxpayer's trade or business (or, in the case of an individual, for personal consumption).

[65] Section 493(b)(4).

As we recommended in the 2015 Report,[66] we recommend that the exclusion for compensatory options be extended to exclude other form of equity-linked compensation (such as restricted stock units), that merger and acquisition agreements be excluded, and that transactions by individuals of a kind such that any expenses or losses from it would not be deductible under section 212 also be excluded (so that "consumer" transactions like mortgage rate-lock agreements would be excluded from the definition of derivative).

O. Exclusion for Securities Lending, Sale-Repurchase and Similar Financing Transactions

MODA provides that, to the extent provided by the Secretary, derivative does not include the right to return the same or substantially identical securities transferred in a securities lending transaction, sale-repurchase transaction, or similar financing transaction.[67]

As we recommended in the 2015 Report,[68] we would modify the rule in section 493(b)(3) to exclude these transactions from the definition of derivative without the need for regulations. Congress could grant Treasury the authority to subject certain securities loans, repos, and similar transactions to derivative treatment in appropriate situations.

P. Look-Through Rule for Flow-Through Entities

Section 492(e)(3)(B) provides that if part or all of the income, gain, loss, or expense with respect to a derivative or underlying investment held by a partnership, or other entity would properly be taken into account for purposes of this chapter by the taxpayer, then, except to the extent otherwise provided in regulations, the derivative or investment is treated as held by the taxpayer.

First, we believe that any partnership that holds an underlying investment and a derivative that satisfies the 0.8 delta threshold should recognize built-in gain with respect to the underlying investment and thereafter mark to market the derivative and the underlying investment, regardless of the positions held outside of the partnership by the partners. We believe that a similar rule should apply for straddles.

Second, section 492(e)(3)(B) would require a taxpayer who owns a relatively small interest in an actively traded investment management partnership to be deemed to own a portion of all

[66] 2015 Report at 46.

[67] Section 493(b)(3).

[68] *See* 2015 Report at 46-48.

of the derivatives and underlying investments of that partnership. We do not believe that this rule as written is manageable for taxpayers or administrable by the IRS.

As a general matter, we believe that a look-through rule is manageable and administrable only if the taxpayer has the practicable ability to receive information about a flow-through entity's positions and if the taxpayer has a reasonable amount of time to use that information to make the appropriate elections and identifications. We think it would be manageable and administrable for a rule to provide that a taxpayer is deemed to be able to receive information about a flow-through entity if the taxpayer owns at least 10% of the vote or value of the entity (or 10% of the profits interests in the case of a partnership). MODA should also clarify that a flow-through entity for this purpose includes a CFC (but only if the taxpayer is a United States shareholder), and a PFIC with respect to which a taxpayer has made a "qualified electing fund election." The look through rule should also apply if a principal purpose of an investment in a flow-through entity is to avoid MODA (even if the taxpayer does not own 10% of the vote, value, or profits of the entity).

Q. Accruals of Income, Deduction, Gain, or Loss with Respect to Derivatives

Section 491(d)(1) provides that, except as provided in regulations, in the case of a payment pursuant to a derivative (other than an option), any item of income, deduction, gain or loss with respect to the payment is taken into account at the time of payment and proper adjustment is made in the amount of any subsequent gain or loss for such item.

We suggest two alternative methods. First, all payments with respect to a derivative (including an option), and all payments with respect to an underlying investment that is marked to market (*e.g.*, interest and dividends) be accounted for on an accrual method of accounting (regardless of the method of accounting of the taxpayer), and that this accrual be reported before the derivative or underlying investment is marked to market. Adjustments would be made to future gain or loss with respect to the derivative or underlying investment to account for the accrual. Basis would be reduced by cash payments of prior accruals. This is the method that has been proposed for purposes of section 475.[69]

Alternatively, if a taxpayer has elected mark-to-market treatment for all of its positions, then the taxpayer would not accrue income (like market discount and premium) or expense. Instead, the mark-to-market value would be adjusted for payments.

[69] *See* proposed regulation section 1.475(a)-1(c).

R. Treatment of Partnership Interests That Resemble Derivatives

In the 2015 Report, we noted that partnership interests could be used to replicate derivatives and recommended that authority be granted to the IRS and Treasury to treat partnership interests or other instruments that are close surrogates for derivatives as derivatives where necessary to prevent abuse. We continue to make that recommendation.

S. Coordination with Section 475

Section 492(e)(1)(B) provides that the term underlying investment does not include a security held by a dealer in securities or a dealer in commodities with respect to which an election is in place under section 475(e). Section 3(a) of MODA removes derivatives from section 475. The effect of these two changes is to treat derivatives as governed solely under MODA, to exclude from MODA underlying investments held by dealers in securities and commodities dealers that are marked to market, but to subject to MODA underlying investments that are held by traders that have elected to mark to market their securities under section 475(f).

We would recommend instead that any position (whether an underlying investment or derivative) that is marked to market under section 475 (whether by a dealer or trader) not be marked to market under MODA.[70] We would also grant Treasury and the IRS regulatory authority to conform section 475 to MODA where appropriate, and we would not amend section 475 to exclude derivatives.

We believe that section 475 works well and should not be fundamentally changed, but should produce consistent answers with MODA. Accordingly, if MODA changes the hierarchy for applicable financial statement (see part III.S., below), changes the treatment of accruals with respect to payments on derivatives (see part III.N, above), and changes the source and character of mark-to-market gains and losses, section 475 should be revised to conform. Because we believe that section 475 works well and has been in place for many years, we would give it priority over MODA.

T. Sections 1234 and 1234A

Section 4(a)(1) of MODA would repeal sections 1234 and 1234A. However, because MODA does not apply to all derivatives (such as a contract with respect to interests in real property as defined in section 856(c)(5)(c) that requires physical delivery and, under our recommendations, nonactively traded derivatives), we recommend that sections 1234 and 1234A

[70] However, if a derivative is marked to market under section 475 but an underlying investment is not marked to market under section 475, the underlying investment could be subject to MODA.

be retained, but not apply to any derivative or underlying investment that is subject to mark-to-market taxation.

U. Related Persons

Section 492(e)(3)(A) provides that any derivative or underlying investment held by the spouse of the taxpayer or a member of the taxpayer's consolidated group is treated as owned by the taxpayer for purposes of MODA. As recommended in the 2015 Report, we continue to believe that Treasury should have the 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 application of MODA.[71]

V. Applicable Financial Statements

As explained above, MODA generally follows the hierarchy under regulations section 1.475(a)-4(h) for applicable financial statements, except that the second and third preferences under the section 475 regulations are reversed, and MODA includes additional preferences to deal with taxpayers who report to a foreign agency or government, and grants additional authority to the Secretary to treat a financial statement filed with a designated regulatory or government body to qualify as an applicable financial statement.

We support the expansion of the regulation section 1.475(a)-4(h) regime to include filings with foreign agencies and governments, and to provide the IRS with the authority to designate additional agencies that could receive applicable financial statements. We express no view as to whether the second and third preferences in regulations section 1.475-4(h) should be reversed, but if they are, we recommend that regulation section 1.475(a)-4(h) be amended to conform to MODA, or else some explanation be given for the difference.

W. Straight Debt and Built-in Gain

As discussed above, under MODA, if a taxpayer has an appreciated underlying investment and enters into a hedge that satisfies the 0.7 delta test, the taxpayer must recognize any built-in gain with respect to the underlying investment. We have recommended that the delta 0.7 test be replaced with a 0.8 delta threshold so that the test better conforms with section 1259.

Section 1259(b)(2) provides that an appreciated financial position does not include a position with respect to debt if (i) the position unconditionally entitles the holder to receive a specified principal amount, (ii) the interest payments (or other similar amounts) with respect to the position meets the requirements of section 860G(a)(1)(B)(i), and (iii) the position is not con-

[71] 2015 Report at 63-64.

vertible into stock of the issuer or any related person. We refer to such a position as "straight debt."

As we recommended in the 2015 Report, we recommend that the same exception from 1259 apply to MODA. We make this recommendation to ease compliance and administrability.

Straight debt can appreciate in value and thus taxpayers can hedge straight debt and achieve deferral. However, historically, the appreciation potential with respect to straight debt is much less than with equities. In addition, we believe that compliance with MODA, and its administration, will be much more complicated if interest rate swaps and derivatives could cause built-in gain recognition with respect to straight debt.

X. Debt with Embedded Derivatives

Section 493(c)(1) provides that if a contract has derivative and nonderivative components, then each derivative component is treated as a derivative for federal income tax purposes. If the derivative component cannot be separately valued, then the entire contract is treated as a derivative.

In the 2015 Report,[72] we explained that most of our members believe that debt that contains embedded derivatives should not be deconstructed into its derivative components with respect to holders and, if the treatment of convertible debt is changed, then it should be treated as CPDIs.[73] The reasoning for our recommendation was that it is too difficult to deconstruct and value the components of debt. However, as mentioned in the 2015 Report, we did not reach a consensus on this issue because a debt instrument with a significant derivative component could permit a taxpayer to achieve significant deferral.

We suggest two modifications to our original proposal to address this case.

First, if at issuance, the derivative components that relate to actively traded property represent more than 50% of the issue price, then we recommend that the debt instrument be treated as a derivative for purposes of MODA.

Second, if an instrument provides for an upfront transfer of cash but does not provide for a noncontingent 90% return of the cash and the instrument contains one or more components that, if separated from the rest of the instrument, relate to actively traded property that would be

[72] 2015 Report at 64-71.

[73] It appears, and we have assumed, that derivatives on an entity's own stock are intended to be excluded from MODA. *See* Section 493(b)(6) (excluding derivatives with respect to stock issued by any member of the issuer's worldwide affiliated group, as defined in section 864(f)). This should be clarified, as it is less than perfectly clear that stock of the issuer itself is within this exclusion.

a derivative that is subject to mark-to-market taxation under MODA, then, regardless of whether the instrument is debt or a derivative under common law principles, we recommend that the instrument be treated as a derivative. For purposes of the preceding sentence, the noncontingent 90% return would include any fixed-rate interest, and any interest described in regulation section 1.1275(a)(3) (the variable rate debt instrument rates), after being converted into an equivalent fixed rate as provided in regulation section 1.1275-5(e)(3)(iii). If this approach is not adopted, we had suggested other approaches in the 2015 Report.[74]

Y. Integration of Section 475 and Regulations Sections 1.446-4 and 1.1221-2 with MODA

The section summary of MODA requests comments on whether and to what extent "section 475 taxpayers could be included under the new definitions and rules of the discussion draft, and if not, why not," and "whether and to what extent section 1221 taxpayers who designate hedges could be included under the new definitions and rules of the discussion draft, and if not, why not."[75]

We understand these questions to ask whether section 475 and regulations sections 1.446-4 and 1.1221-2 should be repealed and incorporated into MODA.

Although MODA and section 475 each impose mark-to-market taxation and should be conformed to provide for similar treatment, we see no immediate need to combine the two regimes. Dealers and traders that are subject to section 475 with respect to all of their securities would have no reason to refer to MODA, and we are concerned that an attempt to integrate the two sections could disrupt section 475.

We see even less reason to integrate regulations sections 1.446-4 and 1.1221-2 into MODA. We believe that the purpose of each regime is substantially different. MODA is principally concerned with economic taxation of income; regulations sections 1.446-4 and 1.1221-2 are primarily concerned with eliminating timing and character mismatches for taxpayers that hedge ordinary assets. Regulations section 1.446-4 and 1.1221-2 currently apply where an asset is a security for purposes of section 475, but the hedge is not. If MODA is enacted, we would expect more situations to arise where a derivative is subject to mark-to-market, but the underlying investment is not, and the taxpayer elects to apply regulations sections 1.446-4 and 1.1221-2 to the underlying investment (effectively causing the underlying investment to be subject to

[74] 2015 Report at 64-70.

[75] Senate Finance Committee Ranking Member Senator Ron Wyden, Section-by-Section of Discussion Draft: Modernization of Derivatives Tax Act of 2016, 4 (May 18, 2016).

mark-to-market taxation). Nevertheless, because the purpose of MODA is different than regulation section 1.446-4 and 1.1221-2, we do not see a benefit to combining the regimes.

Z. Reporting Valuation

Section 491(a)(2)(B) provides that a taxpayer may rely on a valuation that is provided to the taxpayer by a broker under section 6045(b) or determined under an applicable financial statement.

The MODA summary requests comments "on whether and how to include additional reporting, such as under section 25 U.S.C. 6045, from dealers and financial institutions."[76]

We believe that brokers could reasonably be required to report the values of derivatives with respect to which they are counterparties, and of the underlying investments they hold for customers. The IRS should have regulatory authority to prescribe methods of valuation, but we generally believe that dealers should be permitted to report any reasonable value, consistently applied, even if that value is not the value that the instrument would be closed out at.

Requiring brokers to keep track of pre-mark-to-market gain and holding period would also be helpful for unsophisticated taxpayers. However, sophisticated taxpayers may not need reporting of pre-mark-to-market gain and holding period.

[76] *Id.* at 4.