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March 6, 2015

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

Gentlemen:

I am pleased to submit the following report on provisions in the discussion draft of potential tax reform legislation released by the House Ways & Means Committee on February 21, 2014 (the "Discussion

Draft") relating to the taxation of financial instruments, and corresponding proposals made in President Obama's fiscal year 2016 budget proposal. The report comments primarily on the proposals relating to the taxation of debt instruments, marking derivative financial instruments to market, the basis of securities and the wash sale rules.

We summarize the proposals and our recommendations and comments below.

A. Debt Proposals

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

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

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

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

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

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

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

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

B. Derivatives Proposals

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

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

The Administration proposal is similar, except that it applies only to derivatives on actively traded property, and the straddle mark-to-market regime applies only to actively traded stock that is hedged. The proposal provides authority for the Secretary to issue regulations to match the timing, source and character of a capital asset and a hedge thereof. The Administration proposal would also bifurcate out a derivative contract embedded in any other financial instrument if the derivative by itself would be marked to market.

Comments and recommendations

In general

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

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

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

3. We recommend that the scope of the mark-to-market regime be limited to derivatives that are linked to actively traded property. Doing so eliminates

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

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

5. We support the exclusion from the scope of these rules for derivatives with respect to stock of members of a worldwide affiliated group.[1] To the extent not addressed by recommendation #3, a derivatives mark-to-market regime should be tailored so that it does not apply to merger & acquisition transactions, non-business or non-investment contracts entered into by individuals, and real estate transactions.

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

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

8. We support the repeal of the "60/40" holding period rules of section 1256. Whether mark-to-market gain or loss from derivatives should be capital or ordinary raises additional issues. For example, treating mark-to-market loss as ordinary means that taxpayers would be able to use losses from

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

derivatives to offset income from their ordinary business operations. In view of the fact that taxpayers would no longer be able to choose the timing of losses, and that any gains would be taxed at ordinary income rates, we agree that ordinary income/loss is the better answer. However, derivatives that otherwise would be capital assets for purposes other than determining the character of gain or loss should continue to be treated as such for those other purposes, in order to avoid inadvertent changes to other areas of the tax law.

Hedging capital assets

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

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

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

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

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

14. If the Discussion Draft's mark-to-market rule for mixed straddles is adopted, we support the exclusion of straight debt from the built-in gain acceleration rule. We recommend, though, that Treasury have authority to expand the built-in gain acceleration rule to straddles involving straight debt in cases of

abuse. We also support the exclusion of exchange-traded covered call options from the built-in gain acceleration rule, particularly in situations where gain is not locked in, but we recommend that the exclusion be extended to "over the counter" traded covered call options, consistent with current treatment under section 1092.

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

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

Embedded derivatives

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

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

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

because it does not require valuation. An accrual approach also eliminates any concerns about issuers marking their own debt to market.

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

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

Convertible Bonds

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

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

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

Derivatives on an Issuer's Stock

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

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

27. We support the Discussion Draft's proposal to tax a corporation on income derived from acquiring its stock and, pursuant to a plan, selling it under a forward contract, subject to comments we have previously submitted.[2]

C. Basis of Securities Proposal

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

Comments and recommendations

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

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

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

4. To make it feasible to apply a single average basis method across all of a taxpayer's accounts, ideally all brokers holding securities for that taxpayer should report information to a single aggregator of that information. Unless information about the taxpayer's basis in securities held in all of its accounts

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

can be pooled in this manner, the benefits of the new cost basis reporting rules under section 6045(g) will be lost. We doubt that the theoretical benefits of an average basis method would be realized in the absence of accurate cost basis reporting.

5. A mandatory FIFO method for determining the basis of portfolio stock has the advantages that it is a well-known method; is readily administrable if applied on an account-by-account basis; arguably is an appropriate realization method; and reduces somewhat the level of electivity in current law. In practice, however, an account-by-account method allows well-advised taxpayers to retain much of the electivity of current law. Accordingly, in our view, mandatory FIFO on an account-by-account basis does not constitute a significant enough improvement over current law to mandate changing current law.

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

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

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

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

Comments and recommendations

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

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

3. We recommend that Treasury be given authority to apply these rules to additional related party transactions under appropriate circumstances. We also recommend that an exception be made for losses realized by a dealer in

the ordinary course of its dealer business. This exception would be modeled on dealer exceptions under section 108 and subpart F under current law.

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We appreciate your consideration of our comments. Please let us know whether you would like to discuss these matters further or if we can assist you in any other way.

Respectfully submitted,

David R. Sicular, Chair

Attachment

cc:

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