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Report No. 1365
February 23, 2017

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Re: *Report on the Discussion Draft of the Modernization of Derivatives Tax Act of 2016*

Gentlemen:

I am pleased to submit the following report on the discussion draft of the Modernization of Derivatives Tax Act of 2016 ("MODA").

We commented in 2015 on two prior mark-to-market proposals for derivatives.[1] 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, as follows:

1. We continue to believe that MODA should be limited to derivatives that are actively traded or that 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 prevent cherry-picking and potentially abusive transactions.

3. We recommend that built-in gain with respect to underlying investment be recognized on entry into a hedge (i.e., that the positions be treated as an "IHU") only if the underlying investment that has a delta relationship to the hedge 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.[2] 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.[3] 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.[4]

[1] We previously commented on similar proposals by Representative 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. *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").

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

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

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

We recommend instead that a 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 treatment 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 income or loss. However, we believe that mark-to-market gains and losses should generally be treated as capital or ordinary, 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 that (i) 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 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 (and therefore does not have an IHU), 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 identified the positions in the straddle. Failure to identify the positions in a straddle properly would not, however, require the taxpayer to recognize built-in gain with respect to the underlying investment. 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.

We make a number of other recommendations described in the report.

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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,

Michael Farber, Chair

Attachment

cc:

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