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Report No. 1389
February 8, 2018

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Re: *Report No. 1389 on the Mark-to-Market Taxation of Derivatives*

Gentlemen:

I am pleased to submit the following report on the topic of a mark-to-market regime for the taxation of derivatives.

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The Modernization of Derivatives Tax Act of 2017 ("**MODA**"), introduced on May 2, 2017 by Senator Ron Wyden, and certain sections of the Tax Reform Act of 2014 (the "**Camp Bill**"), introduced on February 21, 2014 by Dave Camp, the former Chairman of the House Ways and Means Committee, proposed a mark-to-market regime, and we understand that members of Congress are actively considering similar proposals. We refer to MODA and the Camp Bill as the "**Prior Proposals**."

We commented in 2015 and 2017 on the Camp Bill and a discussion draft of MODA.[1] We stated that, although there are both advantages and disadvantages of a mark-to-market taxation regime for derivatives and therefore there is no "right" answer, we continue to believe (as we did in 2015 and 2017) that a mark-to-market regime for derivatives could be a substantial improvement over current law. However, our prior reports emphasized, and this report reiterates, that such a regime would be an improvement only if (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 "mixed" straddles consisting of derivatives and non-derivative positions. This report focuses on these two concerns. We summarize our comments and recommendations below:

Scope of the Prior Proposals

1. We believe that the scope of the Prior Proposals is overly broad and may sweep in many business arrangements and ordinary consumer contracts that we do not believe are intended to be covered. In order to achieve the crucial narrowing of a mark-to-market regime to one that does not result in the scope problems posed by the Prior Proposals, we recommend limiting the definition of "derivative" in the statutory language rather than enacting an overly broad statute and waiting for Treasury and the Internal Revenue Service (the "**IRS**") to create a set of exceptions over time that react to issues encountered in the course of administering the statute. In particular, we continue to feel strongly that a mark-to-market regime should be limited to actively traded derivatives and derivatives with respect to actively traded property and positions, a limitation to which we refer throughout the remainder of this report as an "**Actively Traded Limitation**."[2] Although we are recommending an Actively Traded Limitation in addition to some refinement of other aspects of the definition of "derivative" and not in lieu of such a refinement, an Actively Traded Limitation would mitigate many of the problems posed by the broad definition of "derivative" that we describe in this report.

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[1] *See* N. Y. ST. B. ASS'N, TAX SEC., *Report on the Discussion Draft of the Modernization of Derivatives Act of 2016* (Rep. No. 1365, Feb. 23, 2017), *available at* https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2017/Tax_Section_Report_1365.html (last visited Feb. 2, 2018) (the "**2017 Report**"); 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 Feb. 2, 2018) (the "**2015 Report**").

[2] We use this term generally for ease of discussion in this report. As discussed below, we recognize that the specific parameters of this concept would need to be carefully considered and drafted if this recommendation were adopted in future legislation.

2. We reiterate suggestions raised in our prior reports regarding the potential contours of an Actively Traded Limitation,[3] and we suggest additional rules that could be considered as part of, or in conjunction with, an Actively Traded Limitation. In the prior reports, we observed that all of the following contracts could be deemed to be actively traded: (1) any instrument that is traded on an exchange or the equivalent, or cleared through a central clearinghouse; (2) any financial instrument entered into with a "dealer in securities" within the meaning of Section 475 or an affiliate or special purpose vehicle sponsored or managed by a dealer; and (3) possibly any financial instrument that the taxpayer marks to market for GAAP or regulatory purposes. Conversely, we suggested that contracts with respect to the following items be explicitly excluded from the scope, irrespective of whether such contracts meet the active trading definition: (1) merger & acquisition contracts; (2) intercompany debt or equity; (3) interests in entities with fewer than a specified number of investors; and (4) possibly unique property other than debt, equity, or an instrument treated a security for securities law purposes. In addition to these recommendations, we suggest additional rules to address financial derivatives that the drafters of the Prior Proposals likely intended to cover but that might be excluded by an Actively Traded Limitation, such as over-the-counter derivatives linked to certain types of rates. For example, any derivative entered into by a trader within the meaning of Section 475 could be presumed to meet the actively traded definition. This presumption, combined with a presumption that a contract entered into with a Section 475 dealer is deemed to be actively traded, would assist in ensuring that financial derivatives that might otherwise be excluded by an Actively Traded Limitation are covered by the mark-to-market regime.

3. We also recommend other rules that would serve to prevent the over-inclusiveness of a mark-to-market regime that could harm "Main Street" taxpayers in inadvertent ways (even if an Actively Traded Limitation were adopted), such as a rule excluding from mark-to-market treatment any contract that would be a derivative only by virtue of a term that is ancillary to the primary purpose of the contract (*e.g.*, a merchant contract that includes a penalty for late payments determined by reference to an interest rate). For similar reasons, drafters of a mark-to-market regime might also consider a rule whereby any taxpayer whose total derivatives for the calendar year fall under a specified notional amount could be exempted from the regime.

4. We continue to feel strongly that securities lending arrangements should be excluded from any future mark-to-market regime.

Capital Asset Hedging Rules

1. We continue to advocate for the enactment of a clearer standard for determining which of a taxpayer's positions constitute a derivative and non-derivative combination subject to any capital asset hedging regime. We believe that the legal standards proposed for establishing a straddle or an "investment hedging unit" ("**IHU**") would likely give rise to significant uncertainty and complexity.

2. We believe that the standard proposed in MODA for determining positions that constitute an IHU offers a marginal improvement in clarity over the straddle standard proposed under the Camp Bill. Therefore, if either of the Prior Proposals were to form the basis of

[3] 2015 Report at 42–43, 46; 2017 Report at 7, 17.

future mark-to-market legislation, we favor starting with a definition more akin to the approach provided under MODA and building greater specificity into the statutory language regarding the required relationship (both qualitative and quantitative) between an underlying investment and derivative.

3. We reiterate our recommendation from prior reports that the circumstances triggering the recognition of built-in gain in the non-derivative position in a straddle or IHU (or however future legislation defines these types of mixed transactions) be significantly narrowed, and should be required only if a constructive sale rule applies (whether under Section 1259 or, if Section 1259 were eliminated in future legislation, a similar standard built into the new IHU or straddle rules).

4. MODA requires taxpayers to identify each derivative and the underlying investment to which it relates that are *not* part of an IHU and, if the taxpayer fails to make this identification, the underlying investment and the derivative are treated as an IHU (a rule that we refer to as the "**Failure-to-Identify Rule**") and built-in gain in the underlying investment is recognized. We believe that the Failure-to-Identify Rule will produce an overwhelming compliance burden, and traps for the unwary, and we strongly discourage the implementation of a rule of this nature.

5. We reiterate our comment from our prior reports that, if a delta standard is adopted for determining whether a derivative and non-derivative combination should be subject to a capital asset hedging regime, the -.7 delta threshold proposed under MODA is an insufficient degree of correlation for requiring the acceleration of gain in an underlying investment treated as part of an IHU.[4] Assuming a delta test is adopted in future legislation, we continue to recommend that recognition of built-in gain be limited to transactions where a -.8 delta threshold is satisfied.

6. Finally, we reiterate our support for the exclusion of "straight debt" and "qualified covered call options" from any gain acceleration rule applicable to a capital asset hedging regime, as provided under the Camp Bill.

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,

Karen G. Sowell
Chair

Attachment

[4] *See* the 2017 Report at 18–19.

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Report No. 1389

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED MARK-TO-MARKET LEGISLATION

February 8, 2018

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New York State Bar Association Tax Section

Report on Proposed Mark-to-Market Legislation
February 8, 2018

I. SUMMARY OF COMMENTS AND RECOMMENDATIONS[1]

In prior reports,[2] we commented on the discussion draft of the Modernization of Derivatives Tax Act of 2016, released on May 18, 2016 by Senator Ron Wyden, and certain sections of the Tax Reform Act of 2014 (the "**Camp Bill**"), introduced on February 21, 2014 by Dave Camp, the former Chairman of the House Ways and Means Committee.[3] On May 2, 2017, Senator Wyden introduced the Modernization of Derivatives Act of 2017 ("**MODA**") as a bill to Congress, with some modifications to the May 18, 2016 discussion draft. Throughout this report, we refer to MODA and the Camp

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[1] The principal author of this Report is Lucy Farr, with substantial assistance from Rachel Lerner, Aliza Slansky and Yixuan Long. Comments were received from Andrew Braiterman, Peter Connors, Michael Farber, Mary Harmon, Robert Kantowitz, Robert Kreitman, Joshua Lingerfelt, John Lutz, Jeffrey Maddrey, David Miller, Erika Nijenhuis, Orla O'Connor, Eschrat Rahimi-Laridjani, David Schizer, Michael Schler, and Edward Wei. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the NYSBA Executive Committee or the House of Delegates.

[2] *See* N. Y. ST. B. ASS'N, TAX SEC., *Report on the Discussion Draft of the Modernization of Derivatives Act of 2016* (Rep. No. 1365, Feb. 23, 2017), *available at* https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2017/Tax_Section_Report_1365.html (last visited Feb. 2, 2018) (the "**2017 Report**"); 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 Feb. 2, 2018) (the "**2015 Report**").

[3] 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 Feb. 2, 2018). 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* https://waysandmeans.house.gov/camp-releases-tax-reform-plan-to-strengthen-the-economy-and-make-the-tax-code-simpler-fairer-and-flatter/ (last visited Feb. 2, 2018).

Bill as the "**Prior Proposals**." We understand that either Prior Proposal could form the basis for any future legislation establishing a mark-to-market regime for derivatives. Accordingly, in this report, we focus on specific recurring themes and issues that are present in both Prior Proposals. We reiterate important concerns expressed in prior reports, concerns that we believe are critical to address in order for any future mark-to-market regime to be an improvement over current law. In the sections that follow, we discuss two key issues: (i) our concerns about the scope of the Prior Proposals and (ii) the significant uncertainty and high compliance burden that we anticipate would arise under the capital asset hedging rules in the Prior Proposals. We summarize our comments and recommendations below:

A. Scope of the Prior Proposals

The scope of the mark-to-market regime, as proposed in each of the Prior Proposals, is much too broad and would pick up many transactions that we do not believe should be marked to market. To illustrate this concern, we describe several examples of the types of non-financial transactions that would be covered by the Prior Proposals. In particular, the prong of the definition of "derivative" in both of the Prior Proposals covering "any contract . . . the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to . . . any rate, price, amount, index, formula, or algorithm" sweeps in many business arrangements and ordinary consumer contracts that we do not believe are intended to be covered.

1. In order to achieve the crucial narrowing of a mark-to-market regime to one that does not result in the scope problems posed by the Prior Proposals, we recommend limiting the definition of "derivative" in the statutory language rather

than enacting an overly broad statute and waiting for Treasury and the Internal Revenue Service (the "**IRS**") to create a set of exceptions over time that react to issues encountered in the course of administering the statute. In particular, we continue to feel strongly that a mark-to-market regime should be limited to actively traded derivatives and derivatives with respect to actively traded property and positions, a limitation to which we refer throughout the remainder of this report as an "**Actively Traded Limitation**."[4] Although we are recommending an Actively Traded Limitation in addition to some refinement of other aspects of the definition of "derivative" and not in lieu of such a refinement, an Actively Traded Limitation would mitigate many of the problems posed by the broad definition of "derivative" that we describe in this report.

2. We reiterate suggestions raised in our prior reports regarding the potential contours of an Actively Traded Limitation,[5] and we suggest additional rules that could be considered as part of, or in conjunction with, an Actively Traded Limitation. In the prior reports, we observed that all of the following contracts could be deemed to be actively traded: (1) any instrument that is traded on an exchange or the equivalent, or cleared through a central clearinghouse; (2) any financial instrument entered into with a "dealer in securities" within the meaning of Section 475 or an affiliate or special purpose vehicle sponsored or managed by a dealer; and (3) possibly any financial instrument that the taxpayer marks to

[4] We use this term generally for ease of discussion in this report. As discussed below, we recognize that the specific parameters of this concept would need to be carefully considered and drafted if this recommendation were adopted in future legislation.

[5] 2015 Report at 42–43, 46; 2017 Report at 7, 17.

market for GAAP or regulatory purposes. Conversely, we suggested that contracts with respect to the following items be explicitly excluded from the scope, irrespective of whether such contracts meet the active trading definition: (1) merger & acquisition contracts; (2) intercompany debt or equity; (3) interests in entities with fewer than a specified number of investors; and (4) possibly unique property other than debt, equity, or an instrument treated as a security for securities law purposes. In addition to these recommendations, we suggest additional rules to address financial derivatives that the drafters of the Prior Proposals likely intended to cover but that might be excluded by an Actively Traded Limitation, such as over-the-counter derivatives linked to certain types of rates. For example, any derivative entered into by a trader within the meaning of Section 475 could be presumed to meet the actively traded definition. This presumption, combined with a presumption that a contract entered into with a Section 475 dealer is deemed to be actively traded, would assist in ensuring that financial derivatives that might otherwise be excluded by an Actively Traded Limitation are covered by the mark-to-market regime.

3. We also recommend other rules that would serve to prevent the over-inclusiveness of a mark-to-market regime that could harm "Main Street" taxpayers in inadvertent ways (even if an Actively Traded Limitation were adopted), such as a rule excluding from mark-to-market treatment any contract that would be a derivative only by virtue of a term that is ancillary to the primary purpose of the contract (*e.g.*, a merchant contract that includes a penalty for late payments determined by reference to an interest rate). For similar reasons,

drafters of a mark-to-market regime might also consider a rule whereby any taxpayer whose total derivatives for the calendar year fall under a specified notional amount could be exempted from the regime.

4. We continue to feel strongly that securities lending arrangements should be excluded from any future mark-to-market regime.

B. Capital Asset Hedging Rules

In the second part of this report, we identify key issues with the proposed capital asset hedging rules, *i.e.*, rules applicable to "mixed" straddles that include both a derivative and a non-derivative position. We believe that (i) the Prior Proposals are unclear in defining which positions are part of an "investment hedging unit" ("**IHU**") or straddle (as applicable) and (ii) the requirement under the Prior Proposals to recognize built-in gain in the non-derivative component of an IHU or straddle (as applicable) would apply to an unreasonably broad range of transactions.

1. We continue to advocate for the enactment of a clearer standard for determining which positions constitute a derivative and non-derivative combination subject to any capital asset hedging regime. We believe that the legal standards proposed for establishing a straddle or an IHU would likely give rise to significant uncertainty and complexity. We believe that the standard proposed in MODA for determining positions that constitute an IHU offers a marginal improvement in clarity over the straddle standard proposed under the Camp Bill.[6] Therefore, if either of the Prior Proposals were to form the basis of future mark-to-market

[6] In particular, *see infra* note 40 and accompanying text.

legislation, we favor starting with a definition more akin to the approach provided under MODA and building greater specificity into the statutory language regarding the required relationship (both qualitative and quantitative) between an underlying investment and derivative.

2. We reiterate our recommendation from prior reports that the circumstances triggering the recognition of built-in gain in the non-derivative position in a straddle or IHU (or however future legislation defines these types of mixed transactions) be significantly narrowed, and should be required only if a constructive sale rule applies (whether under Section 1259 or, if Section 1259 were eliminated in future legislation, a similar standard built into the new IHU or straddle rules).

3. MODA requires taxpayers to identify each derivative and the underlying investment to which it relates that are *not* part of an IHU and, if the taxpayer fails to make this identification, the underlying investment and the derivative are treated as an IHU (a rule that we refer to throughout the remainder of this report as the "**Failure-to-Identify Rule**") and built-in gain in the underlying investment is recognized. We believe that the Failure-to-Identify Rule will produce an overwhelming compliance burden, and traps for the unwary, and we strongly discourage the implementation of a rule to this effect.

4. We reiterate our comment from our prior reports that, if a delta standard is adopted for determining whether a derivative and non-derivative combination should be subject to a capital asset hedging regime, the -.7 delta threshold

proposed under MODA is an insufficient degree of correlation for requiring the acceleration of gain in an underlying investment treated as part of an IHU.[7] Assuming a delta test is adopted in future legislation, we continue to recommend that recognition of built-in gain be limited to transactions where a -.8 delta threshold is satisfied.

5. Finally, we reiterate our support for the exclusion of "straight debt" and "qualified covered call options" from any gain acceleration rule applicable to a capital asset hedging regime, as provided under the Camp Bill.

II. CONCERNS ABOUT THE SCOPE OF THE PRIOR PROPOSALS

A. The Scope of the Prior Proposals is Overly Broad

The transactions that would be subject to mark-to-market treatment under the Prior Proposals are generally the same. The definition of "derivative" in each bill is similar, with minor deviations between the proposals with respect to the list of exceptions to that definition.[8] The scope of the transactions that would be covered under this

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[7] *See* the 2017 Report at 18–19.

[8] *Compare* Section 493 of MODA *with* Section 486 of the Camp Bill. Both proposals define "derivative" broadly as "any contract (including any option, forward contract, futures contract, short position, swap, or similar contract) the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to" one or more of the following: corporate stock; a partnership or trust interest; any evidence of indebtedness; real property (subject to certain exclusions); any actively traded commodity; any currency; any rate, price, amount, index, formula or algorithm; and any other item prescribed by the Treasury Department. Both exclude (1) certain contracts with respect to real property, (2) contracts that are part of a hedging transaction (as defined in Section 1221(b)) and Section 988 hedging transactions (as defined in Section 988(d)(1)), (3) options described in Section 83(e)(3) received in connection with the performance of services, (4) insurance contracts, annuities and endowment contracts, (5) derivatives with respect to stock issued by an affiliate, and (6) contracts with respect to commodities used in normal course of trade or business that require physical settlement. Both leave the authority to exclude securities lending and repo transactions to the Secretary instead of providing a statutory exception. The primary difference between the definitions of "derivative" in the two proposals is with respect to the exclusion for certain real property contracts. MODA excludes any such contract that requires physical

language would be extremely broad, in that it would include contracts the value of which, or any payment or transfer with respect to which, is determined by reference to a long list of items including stock, debt, partnership interests, real property, certain commodities and currencies, as well as any "rate, price, amount, index, formula or algorithm." A contract would generally be in scope regardless of whether it, or the underlying item, is actively traded, and regardless of whether a derivatives dealer is one of the parties.[9]

We are concerned that the breadth of the Prior Proposals may not be widely appreciated, notwithstanding the inclusion in our prior reports of examples of situations that illustrated the proposals' surprising breadth as well as similar observations by other commentators. Because we view the scope issue as critical to the creation of a workable mark-to-market regime, we reiterate in subsection II.B. below some of our prior examples and add new ones. The examples serve to demonstrate that, without an Actively Traded Limitation and with a broad and vague set of specified items to which a derivative can refer, practically any contract can be a derivative. We understand that this result is not intended and we explore in the discussion below how a more narrow approach could achieve the intended goal of mark-to-market legislation for financial derivatives.

Our tax system is a realization-based system rather than one that measures and taxes a taxpayer's annual accretion to wealth. While the merits of both approaches have been discussed extensively in the academic literature, for our purposes it suffices to

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delivery, while the Camp Bill excludes any contract with respect to a tract of real property (as defined in Section 1237(c)) or any real property that would be property described in Section 1221(a)(1), with respect to the taxpayer if held directly, irrespective of whether the contract provides for cash or physical settlement.

[9] *See* MODA, Section 493; the Camp Bill, Section 486.

observe that there are very good reasons why taxes are generally owed only upon a realization event. These reasons include concepts of fairness and liquidity, on the grounds that a taxpayer can generally benefit from appreciation in the value of an asset only when the asset can be reduced to cash and used for consumption or other investments. They also include practical concerns arising from the difficulty and cost to taxpayers of having to value assets on an annual basis, as well as the risk to the government that arises when taxpayers place values on illiquid assets. Although measuring pure accretions to (or reductions in) wealth may be desirable from a theoretical perspective, as we have previously highlighted in our prior reports, good tax legislation appropriately balances pure tax policy with fairness, complexity and administrability concerns.[10]

We understand from conversations with various individuals involved in the drafting process that the intent behind both of the Prior Proposals was not to effect a dramatic change in the way in which "ordinary" transactions are taxed, but rather to subject transactions that are conventionally understood to be financial derivatives to mark-to-market taxation.[11] Accordingly, if the objective of a mark-to-market tax regime for derivatives is pursued, we believe that the main policy decision at stake is not whether such a regime should focus on financial derivatives, but rather how to draft a provision that applies comprehensively to financial derivatives while excluding other contracts.

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[10] *See* the 2015 Report at 43.

[11] *Cf.* Camp Bill section-by-section summary in *supra* note 3 at 97 ("[u]nder the provision, derivative *financial* transactions generally would be marked to market at the end of each tax year") (emphasis added); MODA section-by-section summary in *supra* note 3 at 2 ("[b]y establishing a single set of straightforward rules governing the tax treatment of these *financial products*") (emphasis added).

To this end, we understand that a choice was made to draft language that is relatively broad in scope (in particular, an Actively Traded Limitation was rejected) out of concern that narrow legislation could be manipulated by taxpayers seeking to avoid mark-to-market taxation, with an understanding that the scope could be narrowed over time by specific exceptions created through the regulatory process as the IRS administers the rules and taxpayers attempt to comply with them.

In theory, such an approach could result in a rational set of rules that divides financial derivatives from other transactions, but only after a significant passage of time as taxpayers and the government come to understand, through experience, the reach of the statute. In the meantime, significant uncertainty and high compliance costs for taxpayers and auditing costs for the IRS would ensue. Many taxpayers would have entered into "derivatives" without realizing it; others would use the breadth of the provision to their advantage by claiming deductions for losses on non-financial contracts that fall within the statutory language. Taxpayers would no doubt take aggressive positions on valuation, since for private contracts on private property there would be no easy benchmark against which the IRS could compare taxpayers' marks. While in time these issues could potentially be addressed, in the short to medium term there could be meaningful harm to the tax system, with the harm to the fisc potentially being greater than the harm to unsuspecting taxpayers.[12]

[12] Drafters of the Prior Proposals may have taken comfort from a view that, as a method of accounting, a mark-to-market regime merely results in temporary differences that will wash out once the relevant contract matures, and therefore that any unintended consequences in the early years of such a regime would not result in significant hardship to taxpayers or harm to the government. While this may be true in some cases, given the breadth of the proposals' scope we believe they could apply to many categories of long-term arrangements. As we pointed out in our example in the 2017 Report concerning the put option granted to two individuals that are equal partners in a partnership, which we reiterate below, if one of the

Mark-to-market would be a significant change from current tax law, as it now generally applies on a mandatory basis only to dealers in securities under Section 475 and to taxpayers entering into Section 1256 contracts. As a result, its effect has historically been limited to very specific categories of exchange-listed, easily valued and liquid transactions (in the case of Section 1256) and to persons in the financial business (in the case of Section 475) or making certain elections.[13] Consequently, our tax system has little experience with applying such a regime to a very broad range of transactions and taxpayers, including less sophisticated taxpayers.

Any new and significant legislation operates in unexpected ways, and a mark-to-market regime would be no exception. Significant Treasury and IRS resources would likely be expended in furtherance of audits and to identify and draft appropriate exceptions to the rules, both to protect taxpayers from unintended gain recognition and to stop taxpayers from using the rule as a sword.[14] As a result, we believe it would not be prudent to impose a new regime in a way that will certainly be initially too broad and hope that it gets sorted out in time.

While there may be other ways of crafting a narrow mark-to-market regime, an Actively Traded Limitation seems to us to be the best way to narrow the scope of such a regime because it functions as a reasonable proxy for conventional financial derivatives,

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parties is tax-indifferent, the incentives of the parties to long-term arrangements likely will be aligned to exaggerate early losses and understate early gains of the tax-sensitive party.

[13] In addition to the mark-to-market election available under Section 475 to traders in securities as well as dealers and traders in commodities, there are much narrower mark-to-market elections available for certain interests in passive foreign investment companies under Section 1296 and notional principal contracts pursuant to proposed regulations under Section 446.

[14] Section 871(m) is a recent example of a statutory provision that has engendered a multi-year regulatory process due to the significant challenges and complexities of drafting workable regulations to interpret it.

while simultaneously limiting covered transactions to those that are more likely to be easily valued. Therefore, as discussed in our prior reports, we continue to recommend that an Actively Traded Limitation be adopted.[15] An Actively Traded Limitation would avoid some potentially intractable valuation issues. As has been demonstrated in other areas of the tax law, particularly in the areas of estate tax and transfer pricing, valuation issues invariably lead to disputes that the government is unlikely to have the resources to litigate. Moreover, an Actively Traded Limitation will increase fairness and decrease liquidity concerns generated by transactions like the examples we describe below.[16]

We acknowledge that adopting an Actively Traded Limitation would inevitably involve significant line drawing, given that levels of trading activity fall on a continuum. However, in our prior reports we suggested some tests that could potentially outline the contours of an Actively Traded Limitation, explicitly including some transactions that may otherwise fail to be picked up and explicitly excluding other transactions that inadvertently may be swept in.[17] We observed that all of the following contracts could be deemed to be actively traded: (1) any instrument that is traded on an exchange or the

[15] We note that the General Explanations of the Administration's Fiscal Year Revenue Proposals for fiscal years 2013-2017 (the "**Administration Report**"), which generally contained similar proposals to those contained in MODA and the Camp Bill, would treat a contract as a derivative subject to mark-to-market if its value is determined "directly or indirectly, in whole or in part" by reference to the value of actively traded property. As we highlighted in the 2015 Report, while we believe the approach in the Administration Report is a marked improvement over the Camp Bill, the Administration Report definition is also overbroad, since it would result in taxpayers being required to mark to market a contract that primarily relates to non-traded assets but also includes a shred of value attributable to actively traded property. 2015 Report, at 42.

[16] First, by limiting covered transactions more definitively to financial transactions, the Actively Traded Limitation better protects "Main Street" taxpayers from hardships resulting from phantom income, as it is less likely that such taxpayers have sufficient other funds to cover the associated tax, as well as the burdens associated with valuing their affected transactions annually. Second, the Actively Traded Limitation decreases the risk that a taxpayer will not be able to borrow against the derivative to obtain cash to cover tax from phantom income due to valuation issues.

[17] 2015 Report at 42–43, 46; 2017 Report at 7, 17.

equivalent, or cleared through a central clearinghouse; (2) any financial instrument entered into with a "dealer in securities" within the meaning of Section 475 or an affiliate or special purpose vehicle sponsored or managed by a dealer; and (3) possibly any financial instrument that the taxpayer marks to market for GAAP or regulatory purposes. Conversely, we suggested that contracts with respect to the following items be explicitly excluded from the scope, irrespective of whether such contracts meet the active trading definition: (1) mergers & acquisition contracts; (2) intercompany debt or equity; (3) interests in entities with fewer than a specified number of investors; and (4) possibly unique property other than debt, equity, or an instrument treated as a security for securities law purposes. Additionally, we continue to recommend an exclusion for equity compensation that is broader than the one provided in the Prior Proposals.

We recognize that an Actively Traded Limitation could exclude certain derivative transactions that Congress or Treasury might view as financial derivatives that should be covered by a mark-to-market regime, depending on how such a limitation is drafted. For example, over-the-counter interest rate derivatives, which are financial instruments that should generally be covered by any mark-to-market regime for derivatives, might not clearly be covered because they do not refer to specific actively traded property. Other derivatives not linked to specific actively traded property but that might be viewed as financial "bets" include derivatives linked to inflation rates, weather observations and housing indices. Although the merits of including these categories of instrument in a mark-to-market regime may be more debatable than those of interest rate derivatives, the drafters of such a regime could reasonably determine to include them.

To the extent that an Actively Traded Limitation would effectively exclude certain financial instruments that Congress or Treasury determines should be covered, we believe that these transactions can be brought under the mark-to-market regime under specific, carefully-drafted rules providing for the inclusion of those instruments. These specific rules could be considered as part of, or in conjunction with, an Actively Traded Limitation. One possible approach to line-drawing with respect to derivatives not linked to any specific property could be similar to that of the straddle rules, in which "personal property" was specifically defined to include notional principal contracts if "contracts based on the same or substantially similar specified indices are purchased, sold or entered into on an established financial market."[18] In addition, a derivative entered into by a trader within the meaning of Section 475 could be presumed to meet the active trading definition (however defined). This presumption, combined with a presumption that a contract entered into with a Section 475 dealer would be deemed to be actively traded, would assist in ensuring that financial derivatives that might otherwise be excluded by an Actively Traded Limitation are covered by the mark-to-market regime.[19]

On the flip side, even with an Actively Traded Limitation, Congress or Treasury could well conclude that certain specific transactions should be excluded, such as merger agreements with respect to publicly traded corporations.[20] As a result, Treasury would

[18] *See* Treas. Reg. § 1.1092(d)-1(c).

[19] Under current law, there is no bright line definition of a "trader" in securities, commodities or derivatives. While beyond the scope of this report, we believe it would be helpful to have greater clarity regarding how many annual transactions cause a taxpayer to be a trader.

[20] As noted below, certain contracts where the reference to actively traded property is minor or ancillary should probably also be excluded.

likely still need to consider tweaks to the statutory language.[21] Nonetheless, we believe that the adjustments required would be considerably less than would be the case without an Actively Traded Limitation in the statute.

We appreciate the concerns of the drafters of the Prior Proposals regarding possible taxpayer avoidance of a narrowly drafted mark-to-market regime. Drafters may be concerned that a taxpayer could transform an actively traded derivative into a non-actively traded derivative, perhaps through the use of special purpose vehicles or similar arrangements. We believe that either statutory language or Treasury regulatory authority to address such arrangements should be sufficient to address this concern.[22] More generally, a key concern seems to arise out of the difficulty of defining "actively traded" and the necessary line-drawing exercises and potential challenges that would result. We acknowledge that the term "actively traded" would need to be defined and could lead to interpretational issues. However, Congress and Treasury have already engaged in this exercise in a number of Code Sections and Treasury Regulations.[23] Thus, Congress has significant precedent from which it could draw features in order to produce an appropriate definition for the mark-to-market regime. Furthermore, Congress could draft a broad anti-abuse rule that allows the IRS to target transactions that are structured to avoid the application of the mark-to-market regime. Although some definitional issues would be unavoidable and inevitably some transactions that should be covered may at least initially slip through the cracks, we think the virtues of a narrow default rule

[21] We made suggestions in this regard in our prior reports. *See* the 2015 Report at 42–43.

[22] *See* the 2015 Report at 40 for similar recommendations.

[23] *See, e.g.*, Sections 1092, 1263, 163(f), 897, 170, 7704, 453, 1472, 871(m), 883, 884, and 1296, and accompanying Treasury Regulations. *See* the 2015 Report at 42 n. 59.

centered around an Actively Traded Limitation, with appropriate anti-abuse authority, far outweigh the potential pitfalls of an overly broad statute. Put another way, the line-drawing needed to create and enforce an Actively Traded Limitation seems significantly less problematic than the need to value private transactions with respect to private property.

We also recommend the consideration of other rules that would serve to prevent the over-inclusiveness of a mark-to-market regime that could harm "Main Street" taxpayers in inadvertent ways (even if an Actively Traded Limitation were adopted). For instance, a rule could be drafted providing that any contract that would be a derivative only by virtue of a term that is ancillary to the primary purpose of the contract would be excluded (*e.g.*, a merchant contract that includes a penalty for late payments determined by reference to an interest rate). The examples described in subsection II.B.d below in which the value of the contract is determined by reference to a "rate, price, amount, index, formula, or algorithm," but the derivative component of the contract is clearly not the central element of the transaction, would be excluded under this rule. For similar reasons, drafters of a mark-to-market regime might consider a rule whereby any taxpayer whose total derivatives for the calendar year fall under a specified notional amount could be exempted from the regime. While such a rule would have the disadvantage of preserving the need for the complex and somewhat inconsistent rules that make up the current regime, it could mitigate the potentially harsh effects of the regime on taxpayers least able to cope with them.

In summary, we continue to believe that the right approach, should a new version of a mark-to-market regime be considered, would be to draft a more narrowly tailored

statute that adopts an Actively Traded Limitation, excluding the types of transactions we describe in the examples below and avoiding the costly process of fixing an overly broad statute over time in a patchwork manner.

B. Illustrative Examples

To illustrate the breadth of the Prior Proposals, we describe below various transactions that we understand are not intended to be captured, but which are apparently covered by the expansive definition of "derivative" and limited exclusive list of exceptions.

a. *Merger & Acquisition Agreements*

Company A offers to acquire from Company X all of the outstanding stock of Company B for $50 million. All three companies are privately-held companies. Company A and Company X sign the contract. The closing is not scheduled to occur until the following taxable year and is contingent on the parties obtaining regulatory approval. Prior to the end of the taxable year, Company B develops a new product, and Company B's value increases significantly. Under both of the Prior Proposals, the acquisition contract is a derivative because its value is determined by reference to stock of a corporation.[24] If Company A is unrelated to Company B, the exception for derivatives with respect to stock issued by a member of the same worldwide affiliated group in which the taxpayer is a member would not apply.[25] Because neither MODA nor the Camp Bill contains a general exception for merger & acquisition contracts and none

[24] Section 493(a)(1) of MODA; Section 486(a)(1) of the Camp Bill.

[25] Section 493(b)(6) of MODA; Section 486(b)(6) of the Camp Bill.

of the other exceptions to the definition of "derivative" in either of the Prior Proposals would apply, Company A would be required to mark to market its contract position at the close of the taxable year.

This example demonstrates the liquidity issue that a broad mark-to-market regime poses. Because the value of Company A's contract has increased from signing to year-end due to Company B's increase in value, Company A could incur significant tax as a result of its rights under the contract, despite the fact that closing is contingent on regulatory approval and Company A has received no actual cash or other assets that it can easily liquidate. Company A may be short of cash and it is conceivable that the currently payable tax liability could impair Company A's ability to close the deal.

In addition to the liquidity issue, this example underscores that MODA produces drastically different tax results for taxpayers that engage in deals that straddle the taxable year-end and those whose deals close within a taxable year. This disparate treatment is difficult to justify. Furthermore, the disparate treatment is inconsistent with principles of tax neutrality, as it could dissuade some taxpayers from engaging in M&A negotiations closer to the end of the taxable year that would otherwise be economically advantageous.

Finally, this example illustrates how mark-to-market treatment can affect more than the timing of gain or loss recognition—in this example, Company A would not have recognized any gain at all in respect of its purchase of the stock of Company B if there were a simultaneous signing and closing of the transaction. To emphasize the absurdity of this result further, suppose that the parties instead structured the acquisition as a tax-free reorganization under Section 368 in which Company A would acquire stock of

Company B from Company X in exchange for Company A stock. Assuming the same facts as described above and that the exchange ratio in the contract does not adjust between signing and closing to account fully for changes in value of Company B, Company A could be required to recognize gain in respect of its right to acquire the stock of Company B in a transaction that is otherwise governed by a non-recognition provision. On the other hand, if Company B's value decreases (and Company A's value remains the same), Company X could be required to recognize gain on an otherwise tax-free transaction (assuming that the contract is not treated as a derivative "with respect to stock issued by an affiliate" of Company X). An otherwise tax-free reorganization would thus turn into a taxable event for either party, simply because the period between signing and closing straddles the taxable year-end.

b. *Joint Ventures*

In the 2017 Report, we provided the following example: Two individuals are equal partners engaged in a small business in an entity taxed as partnership for federal income purposes. 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.[26] Under both MODA and the Camp Bill, this option is a derivative with respect to the partnership interests and would be required to be marked to market each year.[27]

[26] 2017 Report at 16.

[27] Section 493(a)(2) of MODA; Section 486(a)(2) of the Camp Bill.

As we discussed in the 2017 Report,[28] this example highlights the valuation issues posed by a broad mark-to-market regime. Because the partnership interests 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. Although a consistency requirement mandating that counterparties use the same value might mitigate this issue to a certain extent, the issue would still be present if, for example, the buyer were foreign or otherwise tax indifferent (*e.g.*, has extensive net operating losses). We do not believe that the IRS has the resources to litigate these sorts of valuation disputes.

c. *Equity-Linked Compensation*

Individual X, a computer programmer, joins Company F. As part of her compensation package, she receives restricted stock units that would vest in five years if she stays with the company and meets certain performance criteria. This contract is with respect to stock of a corporation and is therefore a derivative under both of the Prior Proposals. Although both of the Prior Proposals contain exceptions for compensatory options, the exceptions are equally narrow and do not cover other common forms of equity compensation, such as restricted stock units.[29] Therefore, Individual X would be required to mark the restricted stock units to market each year.

In addition to emphasizing the liquidity problem this poses for the individual taxpayer, we also note that compensation is already subject to a long-standing and fairly discrete body of tax law. We believe that additional consideration should be given to

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[28] 2017 Report at 16–17.

[29] Section 493(b)(4) of MODA; Section 486(b)(4) of the Camp Bill.

whether the policies underlying a mark-to-market regime for financial transactions are equally applicable to equity compensation. Further thought should be given to whether any countervailing policies that factor into the current tax treatment of equity compensation need to be taken into account before imposing mark-to-market rules upon restricted stock units and similar forms of equity compensation that do not fall under the narrow compensatory option exclusion.

d. *Contracts with Payments Determined by Reference to Rates, Prices, Amounts, Indices, Formulas or Algorithms*

Section 493(a)(7) of MODA and Section 486(a)(7) of the Camp Bill include in the definition of a derivative "any contract . . . the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to … 'any rate, price, amount, index, formula, or algorithm.'" This language, taken literally, would require most contracts to be marked to market. In fact, it is difficult to conceive of examples of contracts that would not be swept up by this definition. The examples below are illustrative of the types of contracts that would be required to be marked to market under Section 493(a)(7) of MODA and Section 486(a)(7) of the Camp Bill as currently drafted without any narrowing limitations.

i. <u>Car Lease Agreement</u>

Individual A enters into a two-year car lease agreement that contains an option to buy the car at the end of the lease period. The monthly lease payments are determined by reference to the manufacturer's suggested retail price, residual value, and negotiated sale price. At the end of the two-year lease period, Individual A has an option to buy the car

for its residual value, which is determined at the outset based on the manufacturer's suggested retail price and the depreciation schedule.

Under Section 493(a)(7) of MODA and Section 486(a)(7) of the Camp Bill, the car lease agreement is a derivative because both the lease payments and the payment upon exercise of the option are determined by reference to a price. Therefore, Individual A would be required to mark the car lease agreement to market each year.

ii. <u>Cell Phone Service Contract</u>

Individual M, a college student, purchases a cell phone. He opts to buy the phone from a cell phone carrier that allows him to pay the purchase price in installment payments of $30 per month for 24 months by signing a specific cell phone contract. If Individual M decides to cancel the contract within 24 months, he is required to pay a cancellation fee that is determined by reference to the remaining installment payments and the remaining term of the contract had it not been cancelled.

Under Section 493(a)(7) of MODA and Section 486(a)(7) of the Camp Bill, the cell phone contract is a derivative because the installment payments are determined by reference to a price and the cancellation fee is determined by reference to both a price and a formula. Individual M would be required to mark the cell phone contract to market each year.

iii. <u>Standard Merchant Contract</u>

Individual Z signs a contract with a chair manufacturer for the purchase of 8 chairs. Payment is not due until the chairs are delivered, which is not expected to occur

until the following taxable year. The contract specifies that if payment is not made within five business days of delivery, a 3% per annum interest rate is imposed.

The contract is a derivative under Section 493(a)(7) of MODA and Section 486(a)(7) of the Camp Bill because payments are determined by reference to a rate.

iv. Pharmaceutical License Option Agreement

Company C, a pharmaceutical company, has developed and owns certain compounds and owns the patents and proprietary information relating to those compounds. Company D, another pharmaceutical company, is considering acquiring a license from Company C for the compounds but first would like to perform some studies to gauge its interest. To accomplish this, Company C and Company D enter into an option agreement containing the following terms: Company C grants Company D an exclusive option to acquire a license during a two-year period in exchange for specified option premium (paid at closing). If Company D indicates that it intends to exercise its option, the price of the license is to be negotiated by the parties in good faith. During the option period, Company D is required to conduct certain studies. Company C supplies Company D with certain materials free of charge, but Company D must bear the cost of certain other materials supplied by Company C. Company D must also disclose discoveries and inventions made by it in the course of the studies to Company C, and Company D must assign all intellectual property rights to Company C. If the option lapses Company D must return all unused materials.

Under Section 493(a)(7) of MODA and Section 486(a)(7) of the Camp Bill, the license option agreement is a derivative because payments (such as the payments for

materials the cost of which Company D is required to bear) are determined by reference to prices.

v. Contract with Formulaic Payment Arrangement

Individual R, an artist, agrees to lend her work to a museum for six months in exchange for a fixed fee plus a share in the admission fees the museum charges from the audiences for that exhibition at the end of the six months. The contract straddles the taxable year-end. The agreement is a derivative because its value is determined by reference to a formula. Individual R needs to mark the contract to market each year.

We believe that the contracts described in examples d(i) through (v) above were clearly not meant to be covered by MODA or the Camp Bill, but a literal application of the statutory language would subject them to mark-to-market treatment. As noted above, we acknowledge that any mark-to-market regime that aims to cover typical financial transactions would need to pick up financial derivatives linked to interest rates, such as LIBOR-linked swaps, and perhaps contracts linked to indices like the Consumer Price Index. We recognize that accomplishing that objective may entail a difficult drafting exercise, involving significant line-drawing, in order to draft an appropriate definition of the rates, indices, and formulas that should be covered. However, we continue to believe that narrower, more tailored definitions, combined with strong anti-abuse authority, would be preferable to broad language that results in unintended hardship, confusion and complexity for many taxpayers.

C. Securities Lending Agreements Should Not Be Marked to Market

In addition to the examples describe above, we continue to advocate strongly for a statutory exclusion for securities lending agreements, without the need for Treasury to promulgate applicable regulations. Both of the Prior Proposals provide regulatory authority to exclude securities lending, sale-repurchase, and similar financing transactions from the definition of derivative, but absent regulation these transactions would be subject to the mark to market regime.

As Congress[30] and experts[31] have recognized over the years, the markets for repos and securities lending "are crucial for the trading of fixed-income securities and equities. Repos are especially important for allowing arbitrage in the Treasury, agency, and agency mortgage-backed securities markets, thus enhancing price discovery and market liquidity. Securities lending markets play key roles in allowing [short selling], both in fixed income and equity markets."[32] Under current law, Section 1058 provides that neither the loan of a security nor its return generally is treated as a recognition event if certain requirements are met. Requiring taxpayers that lend out their securities to mark their securities loan positions to market would dramatically change that result, effectively repealing Section 1058. This consequence would likely discourage mutual funds and insurance companies, as well as individual taxpayers, from lending out their securities. We continue to strongly

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

[31] *See, e.g.*, Tobias Adrian, Brian Begalle, Adam Copeland & Antoine Martin, *Repo and Securities Lending* in Risk Topography: Systemic Risk and Macro Modeling (UNIVERSITY OF CHICAGO PRESS 2014).

[32] *Id.*, at 131.

recommend that securities lending agreements be excluded from the definition of derivative without the need for regulations.

III. Concerns About the Proposed Capital Asset Hedging Rules

Although MODA and the Camp Bill propose distinct approaches for the treatment of capital asset hedging transactions (*i.e.*, "mixed" straddles containing a derivative and a non-derivative), we believe that certain aspects of these proposals present similar challenges that must be resolved before any final version of derivatives reform legislation is enacted. We believe the statutory language of the capital asset hedging rules in both proposals would be unworkable as currently drafted, and the built-in gain recognition rule (for an underlying investment treated as part of an IHU, in the case of MODA, or the non-derivative offsetting position in a straddle, in the case of the Camp Bill) would have a punitive effect on taxpayers, particularly given the breadth of positions that would be subject to gain acceleration.

Under the Camp Bill, both the derivative and an "offsetting position" in a straddle with the derivative would be marked to market and built-in gain in the non-derivative position would be recognized upon entering into a straddle with a derivative. Whether the non-derivative constitutes an "offsetting position" turns on the application of a modified version of the current "straddle" standard under Section 1092(c). Specifically, the Camp Bill would treat two positions as in a straddle if there is a "substantial

diminution in the taxpayer's risk of loss" from holding a position by reason of holding another position. The positions need not be with respect to actively traded property.[33]

Under MODA's proposed IHU rules, both the derivative and "underlying investment" components of an IHU are marked to market and built-in gain in the underlying investment is recognized upon entering into an IHU. An IHU consists of "[e]ach derivative with respect to" an underlying investment held by the taxpayer "which by itself, or in combination with 1 or more other derivatives, has a delta with respect to any portion of the underlying investment" of -.7 or less (the -.7 delta requirement, the "**Delta Test**").[34] An "underlying investment," in turn, "means, with respect to any derivative, any item described" in the list provided in Section 493(a)(1)–(8) and "by reference to which the value of the derivative is determined either directly or indirectly."[35] The IHU rules require taxpayers to identify their IHUs as well as the "derivatives with respect to an underlying investment, and the portions of the underlying investment" which *do not* constitute an IHU (in other words, each derivative and underlying investment combination that does not satisfy the Delta Test). If the taxpayer fails to make this identification, the underlying investment and the derivative are treated as an IHU (the "**Failure-to-Identify Rule**") and built-in gain in the underlying investment is recognized. Taxpayers may elect to treat an underlying investment and all derivatives with respect thereto as an IHU, regardless of whether the Delta Test is

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[33] *See* Sections 485(c)(2)(C), 485(c)(2)(D) of the Camp Bill.

[34] Section 492(a)(1)(B)(i) of MODA.

[35] Section 492(e)(1)(A)(ii) of MODA.

satisfied. The election is irrevocable and applies to all portions of the underlying investment and all derivatives with respect thereto.

A. The Standard for Determining Which of a Taxpayer's Positions Are Part of a Straddle or IHU Is Unclear

It is crucial that any future mark-to-market legislation provide precise rules for determining which non-derivative positions held by a taxpayer are in a straddle, or part of an IHU, with a derivative. In the absence of more precise legislation, we believe that difficult technical and administrative issues will arise, leading to the utilization of significant resources to address the uncertainty—whether in the form of extensive litigation over the proper interpretation of the statute or significant burden placed on Treasury and the IRS to develop regulations and guidance with more specific rules.

We first discuss our concerns with the straddle standard in the Camp Bill. Under current law, there is little guidance regarding when the risk of loss in a particular position satisfies the "substantially diminished" standard of Section 1092(c).[36] Indeed, the JCT Technical Explanation to MODA explains that the meaning of the term "'substantial diminution of risk of loss' . . . has been uncertain since enactment" of the straddle rules, and observes that "[w]ith their broad, sometimes uncertain meaning, the straddle provisions potentially apply to the hedging of all capital assets, whether or not such

[36] Section 1092(c)(3)(A) sets forth a list of certain positions that are presumed to be offsetting (provided that, with respect to Section 1092(c)(3)(A)(i)-(iv), "the value of 1 or more of such positions ordinarily varies inversely with the value of 1 or more other such positions"), but the term "substantial diminution of risk of loss" is not defined in the statute or Treasury regulations. The legislative history to Section 1092 explains that "mere diversification of positions" is not substantial diminution, but does not offer further guidance. S. Rep. No. 97-144 on H.J. Res. 266, 97th Cong., 1st Sess. (July 6, 1981) at 150.

transactions have the potential for abuse."[37] The JCT Technical Explanation to the Camp Bill similarly acknowledges that "'[s]ubstantial diminution of risk of loss' is an undefined term and its meaning is the subject of controversy among practitioners."[38] The Camp Bill would import this uncertainty into a new set of rules with much more at stake. In fact, we understand that part of the rationale for the revision to the straddle rules in the May 2, 2017 version of MODA was to simplify this aspect of current law.[39]

Although taxpayers and the IRS have been living with the ambiguity in the straddle rules since their enactment in 1981, in this letter we focus on that ambiguity because the consequences under the Camp Bill for being wrong, the recognition of all

[37] STAFF OF THE JOINT COMM. ON TAX'N, DESCRIPTION OF THE MODERNIZATION OF DERIVATIVES TAX ACT OF 2016 (May 18, 2016) (the "**JCT Technical Explanation to MODA**"), *available at* https://www.finance.senate.gov/imo/media/doc/JCT%20Technical%20Explanation%20of%20MODA_114-5061.pdf (last visited Feb. 2, 2018), at 10.

[38] STAFF OF THE JOINT COMM. ON TAX'N, JCX-14-14, TECHNICAL EXPLANATION OF THE TAX REFORM ACT OF 2014, A DISCUSSION DRAFT OF THE CHAIRMAN OF THE HOUSE COMMITTEE ON WAYS AND MEANS TO REFORM THE INTERNAL REVENUE CODE: TITLE III – BUSINESS TAX REFORM (the "**JCT Technical Explanation to the Camp Bill**"), *available at* https://waysandmeans.house.gov/UploadedFiles/JCT_Technical_Explanation__Title_III___Business_JCX_14_14__022614.pdf (last visited Feb. 2, 2018), at 149 n. 653.

[39] MODA (as revised in the May 2, 2017 version) would amend Section 1092 to apply a delta test for determining whether a straddle exists, which would be the same as the threshold in the Delta Test for purposes of the IHU Rules. *See* MODA, amended Section 1092(c)(1) ("The term 'straddle' means offsetting positions with respect to applicable property"); amended Section 1092(c)(2) ("A taxpayer holds offsetting positions with respect to applicable property if the taxpayer holds any position which by itself, or in combination with 1 or more other positions held by the taxpayer, has a delta with respect to any other position held by the taxpayer which is within the range beginning with minus 0.7 and ending with minus 1.0. For purposes of this paragraph, positions shall be taken into account whether or not they are in the same applicable property."); amended Section 1092(c)(4) (providing (i) "applicable property" means any item described in Section 493(a)(1)–(3) and (5)–(8) (or substantially the same as those items) and "of a type which is actively traded" and (ii) "derivatives" (as defined in Section 493(a)) are not "positions" for purposes of Section 1092); amended Section 1092(d) (providing that IHUs and hedging transactions are excluded from the straddle rules). The summary released by Senator Wyden accompanying MODA, as revised in the May 2, 2017 version, states that the proposal "streamlines the straddle rules . . . to apply only to (1) offsetting positions not containing instruments that fall under the MODA definition of a derivative and (2) having a delta between minus 0.7 and minus 1.0. As a result, few current transactions will remain under 1092. Taxpayers will also know, based on the financial instruments used, whether a transaction falls under MODA or the straddle rules before making any determination of delta." MODA section-by-section summary in *supra* note 3 at 3.

built-in gain, are significantly greater than under current law. Moreover, we believe that the Camp Bill's use of the straddle standard under Section 1092(c) would be very difficult for taxpayers to comply with, and for the IRS to administer, given the absence of specific language requiring that the "offsetting positions" relate to or reference the same underlying.[40] Specifically, Section 1092(c) provides that "[a] taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding 1 or more other positions with respect to personal property *(whether or not of the same kind)*."[41] Under this standard, the offsetting positions need not be with respect to the same personal property. Accordingly, it is conceivable that, for example, a derivative with respect to one commodity could be a straddle with a position in a different commodity if holding one position sufficiently reduces the risk of the other. A similar conclusion could be reached where a taxpayer holds positions with respect to two different currencies, or an interest rate derivative and bonds that provide for a different interest rate, where the substantial diminution of risk standard is satisfied.

Although not clearly intended, it appears that even positions in two different stocks can be a straddle as long as the "substantial diminution" test is met.[42] If this latter

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[40] Compare with the IHU standard under MODA, which provides that the value of the position constituting a derivative (the relevant contract, or any payment or other transfer with respect to that contract) must be determined "directly or indirectly" by reference to one or more of the enumerated underlying investments in the statute. As discussed below, we believe the application of this "indirect" reference requirement is also very unclear; however, it goes a step further than the Camp Bill's straddle standard in establishing a link between the derivative and non-derivative positions constituting an IHU.

[41] Section 1092(c) (emphasis added).

[42] Because the Camp Bill provides that offsetting positions are treated as being with respect to personal property even if they might not otherwise be with respect to personal property under Section 1092(c), we understand that the limiting principles of Section 1092(d) under current law with respect to straddles that include a position in stock are not applicable. *See* Camp Bill, Section 485(c)(5) ("For purposes of this

reading is correct, unless "substantial diminution" is defined as having a much higher threshold than is currently believed, taxpayers with significant numbers of long and short equity positions would likely have straddles arising from equity positions in companies that do not have any obvious connection to each other besides large capitalization. Many large-capitalization stocks are highly correlated with each other, at least over meaningful periods of time such as six months to a year. For example, over the last half of 2017, based on daily observations, the correlation coefficients for the following pairs of stocks were approximately: 3M Co./Wal-Mart Stores Inc. – 91%; Bank of America Corp./UnitedHealth Group Inc. – 91%; Apple Inc./Visa Inc. – 89%.[43] A taxpayer with a large portfolio would have a huge administrative burden and significant uncertainty in discerning which of its positions were straddles with other positions and therefore marked to market (*i.e.*, subject to gain recognition).

MODA gives rise to similar issues in its lack of precision in defining an underlying investment in an IHU, but adds another layer of complexity with the Failure-to-Identify Rule. MODA does not elaborate on what it means for a derivative to be "with respect to" an underlying investment within the meaning of the statutory language in order for an IHU (or a potential IHU) to exist. The proposed definition of "derivative" requires that the value of the position constituting a derivative (the relevant contract, or

section—''(A) the term 'straddle' has the meaning given such term by section 1092(c) applied *by treating all offsetting positions as being with respect to personal property*, and ''(B) the term 'position' includes any derivative"); *see also* Section 1092(d) (defining the term "personal property" in the case of stock.). Reading these two provisions together, it appears that the standard set forth under Section 1092(d) is not incorporated into the definition of "straddle" under the Camp Bill, and therefore a taxpayer might be found to have established a straddle by holding two offsetting positions in different stock, if one of the positions "substantially diminishes" the risk of loss of holding the other position.

[43] Calculations from online correlation calculator available at buyupside.com, rounded to the nearest percentage point (last visited Feb. 2, 2018).

any payment or other transfer with respect to that contract) must be determined "directly or indirectly" by reference to one or more of the enumerated underlying investments. This use of the term "indirectly" is particularly unclear for purposes of identifying a potential IHU. As discussed above, underlying investments include "a rate, price, amount, index, formula or algorithm." Because a taxpayer cannot actually hold any of those things as an underlying investment component of an IHU, the only way that this prong of the "underlying investment" definition can have meaning in the context of defining an IHU is for a derivative and an underlying to relate to or reference the same rate, index or formula (*i.e.*, one of the items described in Section 493(a)). For example, suppose that a taxpayer holds a derivative linked to the S&P 500 Index and a basket of stocks that is highly correlated and overlapping with the S&P 500 Index. The S&P 500 Index cannot be an "underlying investment" held by the taxpayer, but this combination could be treated as an IHU if the meaning of the term "indirectly" were interpreted as described above—the derivative does not directly reference the basket of stocks, but its value might be viewed as determined "indirectly" by reference to those investments, given that both positions relate in some way to the same index. If this interpretation is correct, the universe of positions that could potentially be part of an IHU by virtue of their shared reference to the same underlying asset is extremely broad and will put an enormous compliance burden on taxpayers to identify positions that constitute an underlying "with respect to" any particular derivative.

The uncertainty in the proposed language is exacerbated by the Failure-to-Identify Rule, which would require taxpayers to identify all possible positions that might be covered by this imprecise language (even if the offsetting positions are not highly

correlated) or recognize gain on all underlying investments subject to the rule. MODA's lack of specificity raises other technical questions and compliance issues. For instance, if more than one investment in a taxpayer's portfolio correlates with a derivative, which underlying investment should be included in the IHU? Further, MODA's proposed rule deeming a partner in a partnership to hold positions held by that partnership will add to the compliance challenges posed by these provisions.[44] It will be particularly challenging for minority partners to attempt to identify positions entered into by the partnership. Again, we stress that MODA imposes this identification burden on the taxpayer (with significant adverse consequences) without regard to whether the potential IHU satisfies the Delta Test. Consider the examples listed immediately below illustrating the breadth and uncertainty of the IHU rules; these examples might not meet the Delta Test, but the combinations of positions would nonetheless need to be identified to avoid the recognition of built-in gain in the underlying investment (as discussed further below):

- A taxpayer purchases shares in an oil company and shorts a corresponding notional amount of oil futures contracts. The value of the shares correlates with the value of the oil futures contracts because both are affected by the price of oil. Under MODA, the futures contracts could potentially be treated as a derivative with respect to the oil company shares, because the value of the futures contracts could be viewed as determined "indirectly" by reference to the value of the shares. If so, the futures contracts and the shares would be an IHU.

[44] MODA, Section 492(e)(3)(B).

- A taxpayer invests in ADRs of an issuer organized and operating primarily in the United Kingdom, and simultaneously purchases a short currency derivative with respect to pound sterling (*e.g.*, a GBP/USD futures contract). The currency derivative does not refer to the ADRs, but could these positions constitute an IHU by virtue of their relationship to the same currency and correlation? What if the taxpayer holds a portfolio of investments in companies organized and operating in the United Kingdom?

- A taxpayer owns a bond (or a portfolio of bonds) the interest payments on which are determined by reference to LIBOR, and simultaneously enters into an equity swap. Under the terms of the swap the taxpayer is required to make payments determined by reference to LIBOR and receives payments determined by reference to the value of the equity. The value of both positions is determined (at least in part) by reference to the same "rate." Is the value of the equity swap therefore determined indirectly by reference to the bonds, and could the positions constitute an IHU?

- A taxpayer holds SPY shares and VIX call options. (SPY is the ticker symbol for the SPDR S&P 500 ETF, which tracks the performance of the S&P 500 Index, and VIX is the ticker symbol for the CBOE Volatility Index, which measures the market's expectation of volatility implied by the price of options on the S&P 500 Index.) VIX does not directly reference SPY. However, assume that SPY and VIX are negatively correlated. If the value of the VIX options in this example were treated as "indirectly" determined by reference to the SPY shares (because

VIX arguably could be treated as "indirectly" referring to the S&P 500 Index), it is possible that these positions would be treated as an IHU.

- A taxpayer holds a portfolio of bonds issued by ABC Corp., a highly rated investment-grade domestic corporation. At the same time, the taxpayer purchases credit protection on an equivalent principal amount of bonds issued by ABC Corp. under a credit default swap. The terms of the swap do not reference any particular bond issued by ABC Corp., but do reference all bonds that are *pari passu* with the purchased bonds. Under MODA, the swap could be a derivative with respect to the portfolio of bonds because the value of the swap could be treated as determined "indirectly" by reference to one or more of the bonds. If so, the portfolio (or some subset of it) and the swap would constitute an IHU. This hypothetical highlights our concerns with the treatment of derivatives that hedge aggregate risk. Assuming there is an IHU here, it is unclear which asset (or assets) should be treated as the "underlying investment."

The discussion and examples above demonstrate that the vague and broad terms of both MODA and the Camp Bill will be extremely difficult for taxpayers to comply with and for the government to administer, and much greater specificity is required to make a version of these rules workable. Therefore, we continue to advocate for the enactment of a clearer standard for determining which positions constitute a derivative and non-derivative combination subject to these rules.

As described above, one of the primary stated goals of the Prior Proposals is the simplification of the myriad rules applicable to derivatives. We believe that the legal

standards proposed for establishing a straddle or an IHU would do a real disservice to this stated goal because these threshold definitional issues would likely give rise to significant uncertainty and complexity. While we have expressed this view in prior reports, we are concerned that the uncertainty inherent in the application of the proposed legal standards might not be fully appreciated, and therefore in the discussion above we have focused on more specifically describing the problems we believe taxpayers will encounter in interpreting and applying the statutory language in the real world.

As a policy matter, we believe that in order to be drawn into any set of rules for capital asset hedging transactions, it is desirable that the derivative and non-derivative positions bear some *qualitative*, as well as quantitative, relationship to each other. In other words, in principle, these rules should not apply merely because a taxpayer happens to have arranged its affairs in a way that causes it to hold positions bearing an inverse relationship with respect to changes in value.[45] The interpretive issues and examples provided above illustrate that this result is possible under the Prior Proposals, and this will be a trap for the unwary.

In the case of stock, for example, without a qualitative standard to provide limits on the breadth of the straddle (or IHU) rules, a taxpayer holding long and short positions in stock would need to run tests of each of its holdings against the other in order to detect pairings, such as the examples listed above, that could potentially meet the substantial diminution standard. Of course there may be specific cases, such as two exchange traded funds holding large stock portfolios with similar economic characteristics, where it would

[45] If there is a concern that taxpayers will use a qualitative standard to avoid the rules, an anti-abuse rule could address extreme cases.

be appropriate to treat otherwise unrelated but highly correlated assets as a straddle (or IHU), based on a rule similar to the "virtual tracking" test found in the existing Section 246 regulations and imported by cross reference into the straddle rules.

Because of our concerns about the breadth of the straddle rules contained within the Camp Bill, we believe that the standard proposed in MODA for determining positions that constitute an IHU offers a marginal improvement in clarity over the straddle standard proposed under the Camp Bill.[46] Therefore, if either of the Prior Proposals were to form the basis of future mark-to-market legislation, we favor starting with a definition more akin to the approach provided under MODA and building greater specificity into the statutory language regarding the required relationship between an underlying investment and derivative. We would be happy to consider further specific potential improvements to the language and provide additional comments in this regard.

B. The Gain Acceleration Provisions of MODA and the Camp Bill Apply to an Unreasonably Broad Range of Transactions

We reiterate our belief stated in prior reports that recognition of built-in gain on a non-derivative position in a straddle or IHU should be limited to circumstances where the taxpayer has eliminated substantially all of the benefits and burdens of ownership of the non-derivative asset, as is currently required under Section 1259. Our view is rooted in the interests of sound tax policy and fairness. Under current law, Congress determined that built-in gain in a constructive sale should be recognized in narrow circumstances where the taxpayer has essentially locked in its gains in an appreciated asset. We do not

[46] In particular, *see supra* note 40 and accompanying text.

believe that the policy concerns underlying mark-to-market treatment for derivatives justify a new "super constructive sale" regime endorsed by MODA and the Camp Bill.[47] Our concerns here relate, in part, to the problems discussed above—the vague and uncertain language of the current proposals could capture a broad universe of transactions for which, in our view, it would be punitive to trigger built-in gain on the appreciated asset a taxpayer continues to own. The gain acceleration rules in MODA and the Camp Bill would go far beyond the scope of Section 1259 and apply to many non-abusive cases, such as where a taxpayer has not hedged all or substantially all of its risk in the non-derivative position or where aggregate risk is hedged. Built-in gain required to be recognized under these rules could be radically disproportionate to the portion of the appreciated asset that is actually hedged.

[47] Both MODA and the Camp Bill cite the interest of simplification as a key political concern. *See* Modernization of Derivatives Tax Act of 2017 Section-by-Section (May 2, 2017), available at https://www.finance.senate.gov/imo/media/doc/MODA%20Section-by-Section.pdf, (last visited Feb. 2, 2018) ("The [MODA] would prevent sophisticated taxpayers from employing derivatives to avoid taxes while radically simplifying one of the most complex and uncertain areas of today's tax code.") (emphasis in original); Wyden Unveils Tax Proposal to Build a Fairer System, available at https://www.finance.senate.gov/ranking-members-news/wyden-unveils-tax-proposal-to-build-a-fairer-system (last visited Feb. 2, 2018) (according to Senator Wyden (D-Ore.), MODA "will help end the 'Tale of Two Tax Codes' and create one fair system with simple and straightforward rules that apply to everyone"). *Cf.* JCT Technical Explanation to the Camp Bill, at 142 ("The [current derivatives] rules are complex and may be uncertain in their application.").

As discussed above, in the case of the Camp Bill, the ambiguous "substantially diminished" standard "potentially appl[ies] to the hedging of all capital assets, whether or not such transactions have the potential for abuse."[48] The straddle rules were enacted as an anti-abuse regime to eliminate "straddle shelters."[49] These anti-abuse rules should not form the basis of a primary rule of taxation in a new capital asset hedging regime. In the case of MODA, similar issues exist, stemming from the lack of clarity in the statutory language and the Failure-to-Identify Rule. As stated in prior reports, we believe that the gain acceleration rule under MODA operates like an anti-abuse rule and the penalty is too harsh.

As noted above, we understand that the one of the primary objectives of the mark-to-market legislation proposed in MODA and the Camp Bill is the simplification of the labyrinth of rules applicable to derivatives, including Section 1092 and Section 1259. However, we are aware of no good policy reason dictating that gain ought to be recognized in the case of every straddle or in the broad set of circumstances provided under MODA. We favor the attempt under MODA (in the May 2, 2017 revised bill) to create a simpler system by aligning the legal standard under the straddle rules with the IHU rules (which, as we understand the proposal, would virtually eliminate the

[48] *Supra* note 37. We note that, under the Camp Bill, positions in respect of "straight debt" and "qualified covered call options" are not subject to the gain acceleration rule. As noted in our prior reports, we support these exclusions.

[49] Prior to the enactment of Section 1092, the classic straddle shelter involved the use of offsetting positions and timing the disposition of those positions in order to generate a short-term capital loss upon disposition of one leg of the straddle and long-term capital gain upon disposition of the other leg. For instance, in year one, the taxpayer could enter into offsetting commodity futures contracts with slightly different settlement dates. Prior to the end of year one, the holder could dispose of the loss position and recognize a short-term capital loss (which could offset unrelated capital gains in that year) and immediately acquire a new position to economically replace the loss leg of the straddle. The holder would then close out the appreciated position in the following taxable year, recognizing long-term capital gain.

application of the current straddle rules), but several other drafting choices under MODA will result in harsh gain acceleration consequences, including the Failure-to-Identify Rule, the -.7 standard of the Delta Test and the vagueness of the statutory language for determining which offsetting positions constitute an IHU.

As discussed in prior reports, we acknowledge that a natural consequence of a new rule marking derivatives to market but not the underlying assets is that a set of rules must be crafted for the taxation of transactions involving both a derivative and non-derivative investment.[50] In the 2015 Report, we discussed the potential tax accounting methods that could be adopted for these transactions, including an alternative potential new set of rules retaining the basic realization framework under current law, but applying matching rules that would limit a taxpayer's ability to accelerate the timing of tax losses not reflective of its economic position and to convert ordinary income into capital gain.[51] Assuming that Congress and Treasury determine it is optimal from a tax policy perspective for both positions to be marked to market *on an ongoing basis*, we cannot agree that it would be good tax policy to force taxpayers to recognize built-in gain in the non-derivative position *upon the establishment of a straddle or IHU* (or however future legislation defines these types of mixed transactions), unless a constructive sale rule applies (whether under Section 1259 or, if Section 1259 were eliminated in future

[50] 2015 Report, at 51.

[51] *See* the 2015 Report, at 51–53, describing three possible options for the rational taxation of a mixed straddle, including (i) subjecting both positions to mark-to-market/ordinary treatment, (ii) treating both positions under conventional realization methods of accounting, and (iii) an alternative new regime, as described in the accompanying text above. One possibility for such an alternative regime is discussed in detail in the 2015 Report: a new capital asset hedging election modeled on the rules under Sections 1221 and 446 for hedging transactions, which would permit taxpayers to elect to match the gain, income, loss and deduction on straddle positions. *See* the 2015 Report at 54.

legislation, a similar standard built into the new IHU or straddle rules). Therefore, we recommend that the circumstances triggering the recognition of built-in gain in the non-derivative position be significantly curtailed in any future mark-to-market legislation, relative to what has been drafted in the Prior Proposals. In other words, even if a broad straddle or IHU standard is retained, the threshold relationship between the derivative and non-derivative positions (whether qualitative or quantitative) should be higher in order to require gain recognition in the non-derivative position.

In particular, if a version of legislation were adopted that is similar to MODA's IHU rules, we believe that the price to pay under the Failure-to-Identify Rule is too high. We have therefore emphasized in this report the overwhelming compliance burden that will result from the Failure-to-Identify rule, given the endless universe of positions that could be deemed an IHU by reason of an "indirect" relationship that might not even come close to a -.7 inverse relationship. Accordingly, we strongly discourage the implementation of a rule of this nature. Further, we reiterate our recommendation that, if a delta standard is adopted, the -.7 delta threshold proposed under MODA is an insufficient degree of correlation for requiring the acceleration of gain in the underlying investment.[52] As discussed in the 2017 Report, hedges with delta of between -.8 and -.7 are not economically similar to a sale, and 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. Thus, assuming a decision is made to adopt a delta test, we continue to recommend that recognition of built-in gain be limited to transactions where a taxpayer has eliminated

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[52] *See* the 2017 Report at 18–19.

substantially all of the benefits and burdens of ownership by satisfying a -.8 delta threshold. In addition, we reiterate our support for the exclusion of “straight debt” and “qualified covered call options” from the gain acceleration rule, as provided under the Camp Bill.