Client Alert.

February 11, 2013

Moving from the Academic to the Legislative: House Ways & Means Committee Proposal Would Require Mark-to-Market for Derivatives and Modify Certain Other Tax Rules Applicable to Financial Instruments

By Thomas A. Humphreys, Remmelt A. Reigersman, David J. Goett and David N. de Ruig

BACKGROUND

For many years, academics have proposed that the U.S. replace the current hodge-podge U.S. federal income tax rules applicable to financial derivatives with a "mark-to-market" regime. In the first significant legislative initiative ever on this topic, Representative David Camp (R. MI), Chairman of the House Committee on Ways and Means, recently released a discussion draft containing proposed legislation to reform the taxation of financial instruments. If enacted, the legislation would apply to most financial instruments beginning January 1, 2014. Designed to be part of a package of comprehensive tax reform, the proposal, if adopted, would radically alter the current taxation of financial products.

Representative Camp styled the proposal as the antidote to the next financial crisis, "The U.S. is a leader in the financial world, but our broken and antiquated tax code has failed to keep up with the rapid pace of financial innovation on Wall Street. The lack of consistent and comprehensive tax policy has contributed to some corporate scandals and the recent financial crisis that devastated our economy and threatened our standing in the global community. Updating these tax rules to reflect modern developments in financial products will make the code simpler, fairer and more transparent for taxpayers; and it will also help to minimize the potential for abuse that has occurred in the past."

MOST DERIVATIVES MARKED TO MARKET

The most significant aspect of the proposal would require "mark-to-market" tax treatment for derivatives. Under current U.S. federal income tax system derivatives are taxed under a variety of regimes. Most of these regimes are based on the realization principle for gains and losses, i.e., gains and losses are taxed only when "realized" for tax purposes. Certain instruments and taxpayers (e.g., Section[1] 1256 contracts and dealers) are subject to mark-to-market regimes while other instruments, e.g., notional principal contracts and contingent payment debt instruments, are subject to a combination of current accrual and realization regimes.

The proposal, if adopted, would require most derivatives to be marked to market; any hedging transactions (which, under the proposal and as discussed below, will include any transaction treated as a hedging transaction for financial accounting purposes), however, will be carved out of the proposal and continued to be subject to

[1] All Section references are to the Internal Revenue Code of 1986, as amended.

Section 1221. The provision, if adopted, would be effective for derivatives acquired, and positions established, on or after January 1, 2014. In addition, the proposal will apply to all derivatives held by dealers, who are currently subject to Section 475 with respect to securities they hold as inventory or for sale. Under the proposal, gains and losses from derivatives would be reported on an annual basis under a mark-to-market system. Under the proposed system, all year-end unrealized gains or losses would be recognized, and the resulting gain or loss would be ordinary. The tax basis of any derivative held at the beginning of the following tax year would be adjusted to take into account gain or loss previously recognized. To the extent provided in regulations, if the fair market value of a derivative is not readily determinable, the value is determined by using the method the taxpayer has adopted for reporting purposes, or as used for obtaining credit. In addition, because the proposal would deem all items of income, gain, loss and deduction with respect to a derivative to be attributable to a trade or business for purposes of determining a net operating loss (or "NOL"), an individual taxpayer would be able to carry any NOL back for two years (and potentially receive a tax refund) and forward for 20 years.

At the heart of the proposed mark-to-market regime is a new – and very broad – definition of derivative. For purposes of the proposal, a derivative would be defined as: (1) any evidence of an interest in, or any derivative instrument with respect to, any (a) share of stock in a corporation, (b) partnership interest or beneficial ownership interest in a partnership interest or trust, (c) note, bond, debenture, or other evidence of indebtedness, (d) certain real property, (e) actively traded commodity, or (f) currency; (2) any notional principal contract; and, (3) any derivative instrument with respect to any interest or instrument described above. Actual stock or debt instruments, however, would not be subject to the mark-to-market regime.

A derivative would also be defined to include any option, forward contract, futures contract, short position, swap, or similar instrument. In fact, the proposal makes it clear that a derivative encompasses non-publicly traded derivatives and reference, as well as swaps that do not technically meet the definition of a swap under current tax law. For example, even swaps based on information other than objective financial indices, such as temperature, precipitation, snowfall, or frost, would be subject to the proposed mark-to-market regime.

Moreover, the proposal would even apply to derivatives embedded in a debt instrument, such as convertible debt. That type of debt instrument would be bifurcated for tax purposes; the derivative component would be marked to market, the debt component would not. Contingent payment debt instruments and variable rate debt instruments, however, would not be subject to the proposed mark-to-market rules.

Finally, the mark-to-market and ordinary treatment rules would apply to all positions in a straddle that includes any derivative to which the provision applies, even if these positions are not otherwise marked to market.

Notably, the discussion draft does not address the treatment of (i) any current income components of a derivative (e.g., distributions made or coupons paid with respect to a derivative prior to its maturity or settlement), or (ii) non-U.S. investors or counterparties.

SIMPLIFICATION OF HEDGING TRANSACTION IDENTIFICATION

The proposal aims to simplify the identification of hedging transactions. The proposed law would treat any transaction that qualifies as a hedge for financial accounting purposes as meeting the identification requirement under Section 1221. A transaction that is treated as a hedge under U.S. GAAP, however, would only be treated as a hedge for tax purposes if it also meets the substantive requirements under current tax law.

ELIMINATION OF COD INCOME RESULTING FROM DEBT RESTRUCTURINGS

Under current law, a borrower may recognize cancellation of indebtedness ("COD") income when a debt instrument is significantly modified, even though the borrower still owes the same actual principal amount it owed before the modification. This can happen, for example, where the fair market value of a debt instrument has declined and either there is an actual exchange of new debt for old debt or the debt instrument is modified in a way that triggers a deemed exchange under Section 1001.

In the case of certain debt modifications, however, the proposal provides that the issue price of the modified debt instrument will be the *lesser* of (1) the adjusted issue price of the existing debt instrument, or (2) the issue price of the modified debt instrument determined under Section 1274 if the debt instrument would be otherwise subject to that section. As a result, if the principal amount of the debt does not change, the debt modification would not result in the recognition of COD income to the borrower. In other words, COD income would not be recognized on transactions where the principal amount does not change and the modified debt has adequate stated interest. Any amount of actual principal forgiven would still result in COD income consistent with current law.

This proposal would apply to the following types of debt modifications: (i) an exchange by the issuer of a new debt instrument for an existing debt instrument of the issuer, or (ii) the amendment of an existing debt instrument, including a significant modification of an existing debt instrument which is accomplished by the issuer and the holder indirectly through one or more transactions with unrelated parties. The proposal does not apply to alter the current definition of when a significant modification of a debt instrument qualifies as an exchange under current tax law. It would apply to transactions after December 31, 2013.

CURRENT INCLUSION OF MARKET DISCOUNT AND "ABOVE-THE-LINE" DEDUCTION FOR BOND PREMIUM

In a significant departure from current law, the proposal would require current inclusion in income of market discount for debt instruments purchased at a discount in the secondary market. Under current law, market discount that accrues while the taxpayer holds the debt instrument is treated as ordinary income, rather than capital gain, upon the disposition of the debt instrument, unless a taxpayer elects to include market discount in income as it accrues.

The proposal, however, would require the holder of a market discount debt instrument acquired after December 31, 2013 to currently include in gross income the market discount, amortized over the post-purchase life of the instrument. The proposal would also apply to all short-term nongovernmental bonds. The amount of taxable market discount would be limited to the amount that reflects increases in the interest rates since the debt instrument was originally issued. Specifically, the proposal would limit market discount to the greater of (a) the original yield on the debt instrument at issuance plus 5%, or (b) the applicable federal rate at the time of acquisition plus 10%. As a result, accrual of market discount would effectively be limited to accrual at prevailing market interest rates. In sum, the proposal would effectively impose parity in the tax treatment of discount vis-à-vis debt instruments purchased in a secondary market transaction and those purchased at original issuance.

The proposal would also authorize the deduction of amortizable bond premium as an "above-the-line" deduction which reduces adjusted gross income.

AVERAGE COST BASIS METHOD REQUIRED FOR MOST SECURITIES

For sales of certain securities on or after January 1, 2014, the proposal would no longer permit taxpayers to specifically identify which shares have been sold for purposes of determining gain or loss. Instead, taxpayers

would be required to use a cost basis averaging rule similar to the method used for redemptions of mutual fund shares and other regulated investment companies.

The proposal provides a grandfathering exception for securities acquired before 2014. These grandfathered securities would be treated as if they were acquired in a separate account.

WASH SALE RULES EXPANDED TO INCLUDE RELATED PARTIES

Finally, the proposal would expand the current scope of the wash sale rules to disallow losses on the disposition of stock or securities if substantially identical stock or securities is acquired by a related party. For purposes of this rule, the definition of a related party includes the taxpayer's spouse, dependents, controlled or controlling entities (e.g., corporations, partnerships, trusts, or estates), and certain qualified compensation, retirement, health and education plans or accounts. The proposal punitively restricts the ability to recognize these disallowed losses by providing that the basis of the substantially identical stock or securities is not adjusted to include the disallowed loss in the case of any acquisition by a related party other than the taxpayer's spouse.

Legislative prospects for the proposal are uncertain but will likely depend in substantial part on whether and when Congress moves ahead with fundamental tax reform.

Contact:

Thomas A. Humphreys
(212) 468-8006
thumphreys@mofo.com

Remmelt A. Reigersman
(212) 336-4259
rreigersman@mofo.com

David J. Goett
(212) 336-4337
dgoett@mofo.com

David N. de Ruig
(212) 336-4059
dderuig@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer*'s A-List for nine straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.