House Ways and Means Committee Discussion Draft Overview, Summary, Draft Proposal, Technical Explanation on Tax Reform for Financial Products, Instruments

Overview of Ways and Means Tax Reform Discussion Draft:

Financial Products

Background. A leading cause of the 2008 financial crisis was the ability to hide and disguise potentially significant risks through Wall Street's use of derivatives and other novel financial products. The rapid growth and abuse of these derivatives contributed to an environment that led to the seizure of our financial system, from which the U.S. economy still has not fully recovered. At the same time, arcane and often inconsistent tax rules governing derivatives and other financial products have fostered tax-shelter opportunities for some investors while imposing prohibitive tax burdens on taxpayers trying to maintain or sell distressed assets – a process necessary to economic recovery.

A December 6, 2011 joint hearing with the Senate Finance Committee, one of the 20 hearings the Ways and Means Committee ("the Committee") held during the 112th Congress on comprehensive tax reform, examined the tax treatment of financial products. Based on testimony received during this hearing and input from tax practitioners, experts and commentators such as the American Bar Association Tax Section, the Committee is releasing a discussion draft of proposals to reform the tax treatment of financial products.

While the discussion draft updates antiquated tax rules that have not kept pace with innovation in the financial-products market, it also makes significant changes to the way the United States taxes financial products. In the interest of transparency, the Committee is soliciting feedback from a broad range of stakeholders, practitioners, economists, and members of the general public on how to improve this proposed set of reforms. This discussion draft follows the October 26, 2011 release of a discussion draft on international tax reform. Like that previous discussion draft, this discussion draft will be considered as part of comprehensive tax reform legislation that broadens the base, lowers rates, and moves the United States to a more economically competitive tax system on a revenue-neutral basis.

Summary of Financial Products Discussion Draft. The discussion draft includes several reforms that would update and rationalize the tax treatment of financial products. Specifically, the discussion draft includes the following proposals:

• Provide Uniform Tax Treatment of Financial Derivatives. The draft would require taxpayers engaged in speculative financial activity—but not business hedging against common risks—to mark certain financial derivative products to fair market value at the end of each tax year, thus triggering the recognition of gain or loss for tax purposes. The tax code already requires or permits mark-to-market accounting for specific financial products, such as certain contracts and options that are traded on exchanges, and for specific taxpayers, such as securities and commodities dealers and traders. Broadly extending mark-to-market accounting treatment to derivatives would provide a more accurate and consistent method of taxing these financial products and make them less susceptible to abuse, without affecting most small investors who normally do not invest in these products. Derivatives that are used by businesses in the ordinary course of their businesses to hedge against price, currency, interest rate, and other risks would not be affected.

• Simplify Business Hedging Tax Rules. For taxpayers that are engaged in hedging business risks, the draft would allow transactions that are properly treated as hedges for financial accounting purposes to be treated as hedges for tax purposes. This taxpayer-favorable proposal would minimize inadvertent failures to identify a transaction as a hedge for tax purposes, even though the transaction satisfies all of the substantive requirements for hedging transaction tax treatment.

• Eliminate "Phantom" Tax Resulting from Debt Restructurings. The draft would reform the tax rules that apply to debt restructurings that do not involve a forgiveness of principal. This change would reduce the prevalence of "phantom" cancellation-of-indebtedness income when debt is restructured—a common practice during economic downturns—thereby creating a more taxpayer-favorable rule.

• Harmonize the Tax Treatment of Bonds Traded at a Discount or Premium on the Secondary Market. For bonds that are acquired on a secondary market at a discount, the draft would require the holder of the bond to recognize taxable income on the discount over the remaining life of the bond—conforming the tax treatment of such transactions to bonds acquired at a discount directly from the borrower. At the same time, the amount of discount to be recognized for tax purposes would be limited to the discount that typically reflects an increase in interest rates that has occurred since the date the bond was originally issued—as opposed to steeper discounts that often reflect deterioration in the creditworthiness of the borrower. The draft also would allow taxpayers to claim "above-the-line" deductions for bonds acquired at a premium on a secondary market.

• Increase the Accuracy of Determining Gains and Losses on Sales of Securities. To simplify tax compliance and administration, and to determine more accurately the amount of gain or loss when a security is sold, the draft would require the cost basis of the security to be based on the average cost basis of all other shares or units of the identical security held by the taxpayer.

• Prevent the Harvesting of Tax Losses on Securities. The so-called "wash sale" anti-abuse rule has been a feature of the tax code for decades. It is intended to prevent taxpayers from harvesting tax losses by selling securities at a loss and then immediately reacquiring the same securities. However, the current law wash sale rule only applies if the same taxpayer sells and reacquires the security, and it can be circumvented using related parties such as spouses, children, or entities controlled by the taxpayer. The draft would reform the wash sale rule so that it applies to transactions involving closely related parties.

Unaddressed Issues. The Committee recognizes that the discussion draft does not address several technical and policy issues that may need to be resolved in final legislation. The Committee invites comments on how to address such issues, in particular those related to:

• Valuing derivatives that would become subject to mark-to-market tax treatment.

• Identifying financial products tax provisions under current law that may become obsolete or may require modification in light of the discussion draft.

- Information reporting rules that may be necessary to implement the discussion draft, including the reporting rules that are contained in the draft.

- Other areas of financial products taxation that are not addressed in the discussion draft.

Summary Description of Ways and Means Discussion Draft:

Financial Products

Provide Uniform Tax Treatment of Financial Derivatives

Current Law. The current law tax treatment of gains and losses from entering into derivative transactions (e.g., futures, forward contracts, swaps, and options) is highly dependent upon the type of derivative, the profile of the taxpayer, and other factors, which can result in very different tax consequences for economically similar transactions.

Discussion Draft Proposal. In order to bring uniformity to the tax treatment of derivatives and more appropriately measure income and loss, the discussion draft generally would require all derivative positions to be marked to market at the end of each tax year so that changes in the value of the derivative result in taxable gain or loss.

- Any gains or losses from marking a derivative to market would be treated as ordinary income or loss.

- For straddles (i.e., offsetting financial positions) that include at least one derivative position, all positions in the straddle would be marked to market with ordinary income or loss treatment, including stock, debt and other financial products that otherwise would not be subject to mark-to-market treatment under this proposal.

- For purposes of determining the amount of mark-to-market gain or loss on a derivative, the proposal would provide regulatory authority to rely upon the fair market value of the derivative that the taxpayer reports for financial or credit purposes.

- The proposal would not apply to common transactions involving derivatives, such as:

o Hedges used by companies to mitigate the risk of price, currency and interest rate changes in their business operations.

o Real estate transactions (e.g., options to acquire real estate).

- The proposal would repeal several tax law provisions that would be superseded by general mark-to-market tax treatment of derivatives, such as provisions that attempt to police the inconsistent tax treatment of derivatives under current law.

The proposal would be effective for derivatives entered into after December 31, 2013.

Simplify Business Hedging Tax Rules

Current Law. Taxpayers are permitted to match the timing and character of taxable gains and losses on certain hedging transactions with the gains and losses associated with the price, currency or interest rate risk being hedged. However, taxpayers can only accomplish such matching tax treatment if they properly identify the transaction as a hedge on the day they enter into the transaction. Often, taxpayers inadvertently fail to satisfy this identification requirement, even though they have properly identified the transaction as a hedge for financial accounting purposes.

Discussion Draft Proposal. The discussion draft would permit taxpayers to rely upon—for tax purposes—an identification of a transaction as a hedge that they have made for financial accounting purposes. This proposal would protect taxpayers from foot faults resulting from the hedge identification tax requirements, while preventing taxpayers from using hindsight to identify a transaction as a hedge (which is the purpose of the hedge identification tax requirements). The proposal would be effective for hedging transactions entered into after December 31, 2013.

Eliminate "Phantom" Tax Resulting from Debt Restructurings

Current Law. When the terms of an outstanding debt instrument are significantly modified, the issue price of the modified debt instrument (i.e., the principal amount of the debt instrument for tax purposes) does not necessarily equal the issue price of the debt instrument prior to modification. In particular, the issue price of the modified debt instrument can be substantially lower than the issue price of the debt instrument prior to modification if the debt instrument has lost significant value since the loan was originally made (e.g., the value of real estate or other collateral supporting the loan has declined)—even if the lender has not forgiven any actual principal owed by the borrower. The reduction in the issue price resulting from the modification of the debt instrument constitutes taxable cancellation of indebtedness income to the borrower, although the borrower still owes the same actual principal amount as was owed prior to the modification. To a significant degree, this problem has prolonged and intensified the past several economic downturns, including the recent financial crisis.

Discussion Draft Proposal. The discussion draft would eliminate the phantom taxable income problem associated with many debt restructurings by generally providing that the issue price of the modified debt instrument cannot be less then the issue price of the debt instrument prior to modification. This floor on the issue price of the modified debt instrument would be reduced by any amount of actual principal that is forgiven (which, through the operation of current law, would result in taxable cancellation of indebtedness income to the borrower in the amount of principal that is forgiven). The proposal would be effective for debt modifications that occur after December 31, 2013.

Harmonize the Tax Treatment of Bonds Traded at a Discount or Premium on the Secondary Market

Current Law. When borrowers issue debt at a discount (i.e., the loan proceeds are less than the principal amount to be repaid), both the borrower and the lender are required to deduct (in the case of the borrower) and include in income (in the case of the lender) the discount as additional interest for tax purposes over the life of the loan. When a bond that already has been issued by the borrower is subsequently purchased on the secondary market at a discount, the purchaser is required to include the discount in taxable income as additional interest but, unlike discount when a loan is initially made, this discount does not have to be included by the holder of the bond until the bond is retired or the holder resells the bond.

The amount of secondary market discount that holders must include in taxable income appears under current law to include discount associated with deterioration in the creditworthiness of the borrower, even though Congress only may have intended current law to apply to discount associated with increases in interest rates.

In the case of bonds issued or acquired at a premium (i.e., the loan proceeds are more than the principal amount to be repaid), the lender or holder of the bond may only deduct the bond premium as an itemized deduction (although the deduction is not subject to the 2-percent floor).

Discussion Draft Proposal. The discussion draft would require purchasers of bonds at a discount on the secondary market to include the discount in taxable income over the post-purchase life of the bond, rather than only upon retirement of the bond or resale of the bond by the purchaser. This proposal would make the tax treatment of secondary market discount consistent with the tax treatment of discount arising when a loan is originally made.

However, the proposal also would limit taxable secondary market discount to the amount that reflects increases in interest rates since the loan was originally made. Specifically, the proposal would limit this amount to the greater of (1) the original yield on the bond plus 5 percentage points, or (2) the applicable Federal rate plus 10 percentage points.

In addition, the proposal would allow taxpayers to claim “above-the-line” deductions for bonds acquired at a premium on a secondary market. The proposal would be effective for bonds acquired after December 31, 2013.

Increase the Accuracy of Determining Gains and Losses on Sales of Securities

Current Law. When a taxpayer purchases shares of a particular company (or other substantially identical securities) at multiple times and at different prices, and later sells some (but not all) of these shares, the taxpayer is permitted to specifically identify which shares have been sold. Even though the shares are substantially identical, current law allows taxpayers to manipulate the amount of taxable gain or loss by identifying which

shares have been sold based upon their basis (i.e., the amount paid by the taxpayer to purchase those particular shares).

Discussion Draft Proposal. The discussion draft would require taxpayers who sell a portion of their holding in substantially identical securities to determine their taxable gain or loss based on the taxpayer's average basis in the securities, including both the securities sold and the securities retained by the taxpayer. This proposal would be coordinated with the recently enacted basis reporting requirements so that taxpayers would continue to be permitted to determine basis in their securities on an account-by-account basis. The proposal would be effective for sales of securities occurring after December 31, 2013.

Prevent the Harvesting of Tax Losses on Securities

Current Law. For decades, the so-called “wash sale” tax rules have prevented taxpayers from artificially creating tax losses on securities that have declined in value by selling the securities at a loss and, within a short time before or after the sale, acquiring the same (or substantially identical) securities. When these rules apply, the loss is deferred until the replacement securities are later sold. However, many taxpayers can avoid the wash sale rules fairly easily by directing a closely related party, such as a spouse or dependent child, to acquire the replacement securities.

Discussion Draft Proposal. The discussion draft would close this loophole by expanding the scope of the wash sale rules to include acquisitions of replacement securities by certain closely related parties, including spouses, dependents, controlled or controlling entities (such as corporations, partnerships, trusts or estates), and certain qualified compensation, retirement, health and education plans or accounts. The proposal would be effective for sales or securities occurring after December 31, 2013.