Section-by-Section of Discussion Draft: Modernization of Derivatives Tax Act of 2016

Senate Finance Committee Ranking Member,
Senator Ron Wyden

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Overview

Each year, trillions of dollars of financial bets called derivative contracts are traded in the U.S. However, the tax rules that apply to derivatives are hopelessly antiquated, needlessly complex, and riddled with loopholes. As a result, sophisticated taxpayers may manipulate the timing or character of underlying investments or the derivative contracts themselves. The Modernization of Derivatives Tax Act (MODA) discussion draft would prevent sophisticated taxpayers from using derivatives to avoid taxes while radically simplifying one of the most complex and uncertain areas of today's tax code. The draft would require mark to market and ordinary income tax treatment for all derivative contracts, sourcing gains and losses to the taxpayer's country of residence. In this way, the draft would apply a simple, straightforward tax regime to all derivative contracts with one timing rule, one character rule, and one sourcing rule – striking nine code sections and streamlining many others in the process. The discussion draft would also introduce a general rule for capital hedging in lieu of the current, complex anti-abuse straddle rules. According to the Joint Committee on Taxation, MODA would raise $16.5 billion over ten years.

The Ranking Member thanks the staff of the Joint Committee on Taxation and Senate Legislative Counsel for their valuable assistance with this draft.

Current Law

There are no general principles governing the taxation of derivative contracts in the United States, but instead a complex set of tax rules and regulations that evolved in piecemeal fashion over time. The existing rules provide differential treatment based on a variety of factors, including: character of tax attribute (ordinary vs. capital), timing of recognition (short-term versus long-term), type of derivative instrument (option, future, forward, or swap, and whether over-the-counter or exchange-traded), disposition of the contract (terminated, exercised, or lapsed), type of settlement (cash vs. physical delivery), intended use of the instrument (investment vs. business hedge), nature of the taxpayer (dealer, trader, or investor; corporation or individual), source of the transaction (U.S. or foreign), and whether the counterparty is a U.S. or foreign person. In addition, taxpayers must consider numerous anti-abuse rules (e.g. straddle and wash sales rules) when they engage in certain derivative transactions. Moreover, these tax rules prescribe federal tax treatment of derivative instruments without regard to their treatment under accounting rules.

Reasons for Change

Complex, inconsistent, and often spotty tax rules allow sophisticated taxpayers to exploit mismatches in the tax treatment of different investments, taxpayers, or intended uses to minimize their tax bill. For example, present law permits taxpayers to use derivatives such as collars to hedge long-held underlying investments and eliminate economic risk while continuing to benefit from low capital gains rates

intended only for taxpayers who bear actual risk. Second, taxpayers can use forward contracts to re-characterize the tax treatment of income or loss, by terminating the forward to lock-in capital gains rates on profits, or holding the forward until expiration to realize ordinary losses that can be used to offset ordinary income. Third, taxpayers who enter into exchange traded futures contracts may receive 60/40 long-term capital gains/ short-term capital gains tax treatment on the gains, without any minimum holding period requirement. Fourth, the so-called straddle rules that limit taxpayers' ability to hedge capital assets for the purpose of selectively realizing losses to offset gains are highly complex and often unenforced. Fifth, treatment of derivatives for book and tax purposes often differs, increasing confusion and complexity for taxpayers. Finally, tax rules and regulations around derivatives have generally failed to keep pace with the innovation in derivative markets. By establishing a single set of straightforward rules governing the tax treatment of these financial products, this draft closes the gaps in the tax code currently exploited by those seeking to avoid tax.

<u>Section 491 – Rules for Treatment of Derivatives</u>

New code section 491 defines taxable events with respect to derivatives (defined in new section 493) and the tax treatment of ensuing gains and losses. Gains or losses on derivatives would be taxable upon termination or transfer at ordinary rates with proper adjustment. Derivatives not terminated or transferred would at the end of each taxable year, be treated is if they were terminated or transferred and then as if repurchased or entered into ("marked to market"), with gains or losses treated as ordinary with proper adjustment. The provision allows taxpayers to rely on book valuation for tax purposes. Gains and losses on a derivative are sourced to the country of residence of the taxpayer (except to the extent that section 871(m) applies to any payments with respect to the derivative).

Similarly, the provision also requires mark to market, ordinary tax treatment for certain combinations of derivatives *as well as* underlying investments, collectively identified as "investment hedging units" (IHUs) (defined in new section 492). With respect to IHUs, a taxable event would include the establishment of the IHU, and thereafter, any modification to the IHU, such as the acquisition, termination, or transfer of any included derivative, or the acquisition, sale, or exchange of any portion of the underlying investment. For example, establishing a capital hedge (i.e., an IHU) with respect to an underlying investment by entering into a derivative would trigger recognition of gains (the character of which would be capital) if the combined derivative plus underlying has a sufficient delta (defined in 492). After the IHU is established, subsequent gains are marked to market and taxed as ordinary income. (Note that the new sourcing rule applies only to income on the derivative; income from the underlying investment continues to be sourced according to current law). When the derivative that is part of the IHU is disposed of, the underlying investment once again receives capital treatment and the holding period is reset. However, on the establishment of an IHU, or as part of any change to the IHU, no built-in losses are realized with respect to the derivative or the underlying investment. Also, for purposes of a taxable event, the taxpayer will determine which portions of an underlying investment have been sold or exchanged on a first-in, first-out basis (unless the taxpayer has otherwise elected an average cost basis method).

The provision addresses the tax treatment of certain payments with respect to the sale or exchange of derivatives that are not option contracts. For example, taxpayers would recognize swap payments in income and make proper adjustment of such payments made or received when they next mark their swaps to market.

<u>Section 492 – Investment Hedging Units</u>

New code section 492 would supersede current anti-abuse straddle rules and constructive sale rules (Secs. 1092 and 1259) with a new general rule for capital hedging (called "investment hedging units" rules or IHUs) for those taxpayers that use derivatives to hedge capital assets. Under this section, taxpayers will be treated as holding IHUs with respect to an underlying investment if there is one or more derivative contracts associated with one or more underlying investments having a "delta" between minus 0.7 and minus 1.0 (indicating a hedge relationship). Delta is defined as the ratio of the expected change of the fair market value of the derivative(s) to any change in the fair market value of the associated underlying investment(s). Taxpayers are required to test for delta when the IHU is first established, and any time it is subsequently modified. The derivative contracts and associated underlying investments will be marked to market and taxed as ordinary income over the period the IHU is in existence (called the "applicable hedging period").

To minimize compliance burdens for taxpayers, the section provides a special IHU election. A taxpayer may elect to forgo the test for delta and simply treat all derivatives with respect to such underlying investment, and all units of such underlying investment, as part of an IHU, following the election. The taxpayer election, once made, is irrevocable and will apply to all subsequently established IHUs. Additionally, IRS will treat taxpayers who fail to properly identify IHUs as making this special election.

Section 493 – Derivative Defined

New code section 493 defines a derivative and makes conforming changes across tax laws. Transactions not included under these rules include those covered under Sec. 475, hedging transactions (Sec. 1221(b)(2)), certain real property and related investments, employee stock options, insurance contracts, annuities, endowments, and certain embedded derivatives in debt instruments.

Conforming and Technical Changes

The provision extends ordinary tax treatment to debt instruments held by certain insurance companies, among other changes. The provision repeals nine code sections (1233, 1234, 1234A, 1234B, 1236, 1256, 1258, 1259, and 1260) and amends or streamlines many others.

Effective Date

The provision would apply to derivative contracts and underlying investments held 90 days after the date of enactment. The provision also provides transition rules with regard to certain taxable events.

Request for Comment

Comments are requested on all aspects of the discussion draft as well as other topics on the taxation of financial products *within 90 days of this release*. The discussion draft sets aside broader questions with respect to tax rates or other base broadening. While the Ranking Member hopes the policies in the discussion draft will provide a basis for broader tax reform, he also believes these proposals stand on their own merits. As such, comments on proposals in the discussion draft will be considered solely in the context of proposals contained in the draft, and no inference will be made with respect to those issues which have been set aside.

Comments on the additional issues listed below are of particular interest to the Ranking Member. All comments should be submitted electronically (preferred) to Financial_Products@finance.senate.gov; or to: Senate Committee on Finance, 219 Dirksen Senate Office Building, Washington, DC 20510.

Additional issues the Ranking Member is considering are listed below:

1. **Coordination with Timing and Character Rules under Section 26 U.S.C. 475:** The discussion draft excludes derivatives and underlying investments held by taxpayers qualifying as securities dealers under 26 U.S.C. 475. The Ranking Member requests comments on whether and to what extent section 475 taxpayers could be included under the new definitions and rules of the discussion draft, and if not, why not.

2. **Coordination with Timing and Character Rules for Hedging Transactions under 26 U.S.C. 1221:** The discussion draft excludes derivatives and underlying investments held by taxpayers designating hedges under 26 U.S.C. 1221. The Ranking Member requests comments on whether and to what extent section 1221 taxpayers who designate hedges could be included under the new definitions and rules of the discussion draft, and if not, why not.

3. **Definition of an Embedded Derivative**: The discussion draft includes certain embedded derivatives in its definition of a derivative. The Ranking Member requests comments on whether and how to improve this definition.

4. **Reporting on Valuation**: The discussion draft provides for coordination of the rules in MODA with rules provided for in other systems, such as financial accounting. The Ranking Member requests comments on whether and how to include additional reporting, such as under Section 26 U.S.C. 6045, from dealers and financial institutions.