

# MODERNIZATION OF DERIVATIVES TAX ACT OF 2021

## SECTION-BY-SECTION

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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) would prevent sophisticated taxpayers from employing derivatives to avoid taxes while simplifying one of the most complex and uncertain areas of today's tax code. The bill 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 bill would apply a simpler, more 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 bill would also introduce a general rule for capital hedging while scaling back the current, complex straddle rules. The Joint Committee on Taxation said last year MODA would raise \$16.5 billion over ten years.

### 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 many 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, types of 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 most economic risk while continuing to benefit from lower capital gains rates intended 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/ short-term 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 requirements like "substantial diminution of risk" are unenforceable. 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 innovation in these instruments. By establishing a single set of straightforward rules governing the tax treatment of these financial products, this bill closes key gaps in the tax code currently exploited by those seeking to avoid tax.

### **Section 491 – Rules for Treatment of Derivatives**

New code section 491 defines taxable events with respect to derivative contracts (defined in new section 493) and the tax treatment of ensuing gains and losses. Gains or losses on derivatives are taxable upon termination or transfer at ordinary tax rates with "proper adjustment" (that is, adjustments made for gain or loss recognized as a result of any prior taxable event). Derivatives not terminated or transferred during a taxable year are treated as if terminated or transferred at the end of each taxable year and then as if repurchased or entered into ("marked to market"), with gains or losses taxed at ordinary rates 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 IRC section 871(m) applies to any payments with respect to the derivative). Note, however, that income from the underlying investment continues to be sourced according to current law.

The provision, as part of a new capital hedging regime, also requires taxpayers to identify certain combinations of derivatives and underlying investments as "investment hedging units" (IHUs) if these combinations have a sufficient delta relationship (defined in new code section 492). A taxable event with respect to IHUs would include (1) the establishment of the IHU; and thereafter (2) any modification to the IHU, such as the acquisition, termination, or transfer of any included derivative; and (3) the acquisition, sale, or exchange of any portion of the underlying investment. For purposes of a taxable event, the taxpayer will determine which portions of an underlying investment have been sold or exchanged in the same manner as if there had been an actual sale or exchange.

Establishing an IHU will trigger realization of any taxable long-term or short-term capital gains in the underlying investment as if it were sold or exchanged at fair market value immediately before establishment of the IHU. (However, no built-in losses are realized with respect to the derivative or the underlying investment on the establishment of an IHU, or as part of any change to the IHU.) Thereafter, subsequent gains in *both* the derivative and underlying investment components of the IHU are marked to market and taxed as ordinary income. When the derivative component of the IHU is disposed of, the underlying investment is once again taxed according to its character in the hands of the taxpayer. The holding period for such underlying investments is tolled, i.e., will not include any period such investment is part of an IHU.

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 will recognize notional principle contract (i.e., "swap") payments in income and make proper adjustment of such payments made or received when they next mark their swaps to market.

### **Section 492 – Investment Hedging Units (IHUs)**

New code section 492 establishes a general rule for capital hedging called "investment hedging units" for taxpayers using derivatives to hedge capital assets, replacing current anti-abuse straddle rules and

constructive sale rules (IRC secs. 1092 and 1259). Taxpayers are treated as holding IHUs with respect to an underlying investment if there are 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 hedging 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 must test for delta when the IHU is first established, and any time it is subsequently modified.

To minimize compliance burdens for taxpayers, the section provides a special IHU election. A taxpayer may forgo the test for delta by electing to treat all derivatives with respect to such underlying investment, and all units of such underlying investment – whether or not the derivatives and underlying investments are held simultaneously for some portion of that period – as part of an IHU. The taxpayer election, once made, is irrevocable. Additionally, IRS will treat taxpayers who fail to properly identify IHUs as making this special election as described. If the value of a derivative is determined by reference to two or more underlying investments, the Secretary may write regulations to develop methods for determining delta with respect to the multiple underlying investments. Finally, the section provides regulatory authority to streamline the application of IHU rules to taxpayers who own listed options.

### **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 IRC section 475, hedging transactions (IRC section 1221(b)(2)), certain real property and related investments, employee stock options, insurance and annuity contracts, endowments, and certain embedded derivatives in debt instruments.

### **Section 494 – Tax Treatment of Contracts Similar to Derivatives**

New code section 494 clarifies that gains and losses arising from taxable transactions in applicable property interests will receive the same tax treatment as gains or losses from the sale or exchange of the underlying property in the hands of the taxpayer, where an applicable property interest is with respect to property other than property to which new section 493 or revised IRC section 1092 applies.

### **Coordination of New Rules with Existing Rules**

The section streamlines the straddle rules (IRC section 1092) 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. The section also grants Regulated Investment Companies (RICs) indefinite carryforwards of net operating losses to remedy the effect of MODA on certain RIC hedging transactions. It also revises IRC section 1032 to exclude certain derivative transactions of a corporation with respect to its stock from MODA’s definition of a derivative. Finally, the section extends ordinary tax treatment to debt instruments held by insurance companies.

### **Conforming and Technical Changes**

The section repeals nine IRC sections (1233, 1234, 1234A, 1234B, 1236, 1256, 1258, 1259, and 1260) and amends or streamlines many others.

### **Effective Date**

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