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House Ways and Means Committee's Tax Reform Proposals for Financial Products

On January 24, 2013, Rep. Dave Camp (R-Mich), the chairman of the House Ways and Means Committee, released a "discussion draft" of a bill relating to the taxation of derivatives and other financial products (the Discussion Draft). Chairman Camp also issued an accompanying technical explanation of the Discussion Draft (the Technical Explanation) and invited taxpayers to provide comments on the proposed provisions.

The Discussion Draft would overhaul the taxation of derivative financial instruments by imposing a uniform mark-to-market regime with respect to a broadly defined class of "derivatives." It would also modify the tax treatment of more conventional instruments and transactions in a number of important respects, including certain debt instruments, certain business hedging transactions and investments in corporate stock. These proposals raise a number of administrative issues and practical considerations for many different types of taxpayers, from sophisticated financial institutions and investment funds to individual investors.

We believe that the Discussion Draft is likely to be viewed as an important first step in advancing the tax reform discussion as it relates to financial products. Much like Chairman Camp's previous international tax reform proposal, we expect that the Obama administration, the private sector and members of Congress on both sides of the aisle will take the Discussion Draft seriously. Chairman Camp's invitation for comments offers an important opportunity for stakeholders to provide feedback on the policy and technical aspects of the proposals, an opportunity that has been unavailable in connection with recent tax legislation.

While we do not know whether (or when) comprehensive tax reform will happen, we expect that Chairman Camp and other members of Congress will be pushing very hard to advance such legislation in the near term (including a "mark-up" of a comprehensive tax reform proposal later this year). Many consider tax reform a necessary component of any larger deal on spending and entitlement reform to address fiscal issues and the recurring budget crises. The president also specifically highlighted tax reform in his recent inaugural address, and the Obama administration continues to discuss revenues even after the enactment of The American Taxpayer Relief Act earlier this year. Moreover, if comprehensive tax reform efforts ultimately fall short, specific proposals in the Discussion Draft may gain traction as part of a smaller bill.

The following highlights several key aspects of the Discussion Draft.[1]

Uniform Mark-to-Market Regime for "Derivatives"

The Discussion Draft would require all taxpayers to report gains and losses from derivatives under an annual mark-to-market method. Each derivative held by a taxpayer would be treated as if it were sold on the last business day of the taxable year for its fair market value. Any resulting gain or loss would be treated as ordinary gain or loss.

1 The full texts of the Discussion Draft and the Technical Explanation are available at http://waysandmeans.house.gov/taxreform/default.aspx.

The term derivatives would generally include (1) any evidence of an interest in, or any derivative financial instrument with respect to, stock in a corporation, an interest in a partnership or trust, an evidence of indebtedness, real property (subject to narrow exceptions for real estate dealers and single tracts of real property), actively traded commodities or currency; (2) any notional principal contract; and (3) any derivative financial instrument (including an option, forward contract, futures contract, short position, swap or similar instrument) with respect to an interest or instrument described in (1) or (2).[2] Notably, the proposed mark-to-market regime would also apply to all positions of a straddle that includes any "derivative," including a position that is not a "derivative." In addition, the definition of "notional principal contract" in the Discussion Draft is significantly broader than its current definition under Treasury regulation section 1.446-3.[3] As noted in the Technical Explanation, the mark-to-market rules would apply to a number of contracts (such as weather derivatives and credit default swaps) that arguably are not currently subject to the rules of Treasury regulation section 1.446-3.

The Discussion Draft would generally bifurcate any debt instrument that includes an "embedded derivative component" — generally, any terms that affect some or all of the debt instrument's cash flows or the value of its other required payments "in a manner similar to a derivative" — into separate debt instrument and derivative components. The resulting derivative would be subject to the proposed mark-to-market regime. Although the Technical Explanation indicates that convertible debt instruments are a particular target of the bifurcation rule, the broad definition of "embedded derivative component" would potentially reach a much wider range of debt instruments.[4]

The Technical Explanation states that the term derivative is intended to be read expansively and that it would apply to privately held as well as publicly traded interests and instruments. The definition would appear to include interests in an entity that is a pass-through for U.S. federal income tax purposes such as an investment partnership (*e.g.*, a private equity or hedge fund) or a grantor trust that owns stock, debt or other derivatives. In addition, as drafted, the inclusion of forward contracts in the definition of derivative could potentially apply to a wide range of ordinary business transactions such as a stock purchase or merger agreement that does not have a simultaneous signing and closing. The broadly worded definition would also apply to typical private lending situations where the lenders also receive warrants. Although likely unintended, the literal definition of derivative in the Discussion Draft could arguably be read to include directly held stock and debt instruments given the reference to "any evidence of an interest" in stock or debt. Presumably the definition was not intended to cover compensatory options issued to service providers, although it would be helpful for the drafters to confirm this point. Application of the mark-to-market regime to non-compensatory options issued by partnerships raises the potential for disparity between "inside" and "outside" tax basis if the holder exercises the option and departs from the approach taken in proposed regulations that the Treasury and IRS are expected to finalize soon.

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2 The Discussion Draft excludes from the definition of "derivative" any business hedging transaction that qualifies as a "hedging transaction" under Section 1221(b)(2) and Treasury regulation section 1.1221-2. Unless otherwise indicated, all Section references refer to the Internal Revenue Code of 1986, as amended.

3 Specifically, any swap providing for two or more payments (including where two or more payments are rolled into a single payment) would generally be considered a notional principal contract under the Discussion Draft so long as its payments are determined by reference to an index based on (1) a rate, price or amount, whether fixed or variable, or (2) information that is not within any party's control or unique to any party's circumstances. The broader definition generally conforms to recent proposed revisions to Treasury regulation section 1.446-3 and would cover swaps on weather-related risks such as temperature and snow.

4 A debt instrument would not be treated as having an embedded derivative component merely because it (1) is denominated in a nonfunctional currency or provides for payments determined by reference to the value of a nonfunctional currency or (2) is a variable rate debt instrument, a contingent payment debt instrument or a debt instrument with alternative payment schedules. Certain aspects of the bifurcation rule for debt are not entirely clear; for example, if convertible debt also were a contingent payment debt instrument, would the debt qualify for this exclusion from bifurcated treatment because, under the contingent payment debt regulations, the conversion feature is treated as a contingent payment?

The Discussion Draft would repeal Section 1256, which currently provides partial long-term capital gain treatment for futures and exchange-traded options. The Discussion Draft also proposes to amend the Section 475 rules so that dealers must mark-to-market all derivatives they hold (and not just the ones held as inventory or for sale to customers, etc.).

The proposed mark-to-market regime raises the principal difficulty of valuation. This new paradigm would generally require taxpayers to determine the fair market value of derivatives on an annual basis. Privately negotiated derivative instruments — convertible debt of a private company or an option to acquire stock of a private company, for example — are essentially bilateral contracts with bespoke legal and economic terms that often make it difficult, if not impossible, to provide an accurate estimate of the instrument's value at any given point in time. The Discussion Draft would grant the Treasury Department regulatory authority to allow the value of a derivative to be determined in accordance with the taxpayer's financial accounting method in instances where fair market value is not readily ascertainable. Nevertheless, many taxpayers that invest in derivatives (including most individual investors) do not prepare financial reports.[5]

Cancellation of Debt Relief in Debt Restructurings

Under current law, if the terms of a debt instrument are significantly modified (as determined under Treasury regulation section 1.1001-3), an issuer generally recognizes cancellation of debt (COD) income to the extent that the issue price of the modified (new) debt instrument is less than the adjusted issue price of the unmodified (old) debt instrument. This would generally be the case where the fair market value of the new debt is less than the fair market value of the old debt as of its original issue date and the new debt or old debt is treated as "publicly traded" under Treasury regulation section 1.1273-2(f) at the time of the modification.[6]

The Discussion Draft would alleviate the problem of "phantom" COD income in debt restructurings by providing that, in the case of either an actual or deemed debt-for-debt exchange, the issue price of the new debt instrument is the lesser of (1) the adjusted issue price of the old debt instrument or (2) the issue price of the new instrument that would be determined under Section 1274 if it were subject to that provision. Thus, as long as the new debt instrument bears "adequate stated interest," the issuer would generally recognize COD income, and the new debt instrument would be treated as having original issue discount (OID), only to the extent that the principal amount of the debt instrument was reduced in the restructuring. This proposed change could result in the recognition of phantom income to the holder if its tax basis in the debt were less than the new debt's issue price, which would generally be the case if the holder bought the debt after it became distressed or was otherwise trading at a discount. In that case, the holder would recognize gain unless the debt exchange qualified as a recapitalization. For example, if a fund acquired bank debt of an issuer at a significant discount in anticipation of a restructuring of the debt, the fund might have to recognize the full discount as taxable income at the time of the restructuring, depending on the maturity of the debt. Thus, the proposal may not facilitate restructurings in many cases.

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5 The proposal would impose additional burdens on certain controlled foreign corporations and passive foreign investment companies, which would have to engage in annual valuations in order to report information to their U.S. shareholders.

6 Recently finalized amendments to Treasury regulation section 1.1273-2(f) generally make it easier for debt instruments to be treated as "publicly traded," thereby increasing the likelihood of COD income in a debt restructuring.

Changes to Market Discount Rules

Under current law, if a holder acquires a debt instrument for less than its stated redemption price at maturity (or its "revised issue price" if originally issued with OID), any gain recognized on its subsequent disposition or retirement is generally treated as interest (ordinary income rather than capital gain) to the extent of the debt instrument's accrued market discount. Unlike OID, accrued market discount is not includible in income currently by a holder (unless the holder makes an election to accrue the market discount in income currently). In the case of a financially distressed issuer, technical market discount may reflect a deterioration in the issuer's creditworthiness rather than (or in addition to) an increase in market interest rates.

The Discussion Draft would generally seek to align the market discount rules with the OID rules by requiring the holder of a market discount bond to include market discount in income currently on the basis of a constant-yield accrual method (as opposed to the straight-line accrual method that generally applies under the current market discount rules). It would also aim to limit the application of the market discount rules to the amount of market discount that reflects (very roughly) the increase in interest rates since the debt instrument's original issue date. The Discussion Draft would seek to accomplish this result by providing a bright-line cap on the total amount of includible market discount for any given market discount bond.[7] Together, these proposals may affect the secondary market for corporate bonds and other debt instruments. A favorable aspect of the proposal is that it would eliminate the potential risk under current law that a purchaser of distressed debt would have to treat as ordinary income a significant portion of its realization of the discount in cases where the discount was attributable to a deterioration in the credit quality of the issuer.[8] On the other hand, the current inclusion requirement would be unfavorable for holders who did not purchase market discount bonds on a leveraged basis, especially in cases where the holders did not ultimately realize the amount attributable to the discount.[9] Thus, the proposals may have an adverse impact on the after-tax economics of many distressed debt investments.

In addition, the Discussion Draft would effectively expand the scope of the market discount rules to secondary market acquisitions of interests in partnerships that hold debt instruments. In general, a purchaser of such a partnership interest would be treated as acquiring a proportionate share of any debt instrument held by the partnership at the time of the transfer. Accordingly, any decrease in the debt instrument's adjusted tax basis under Section 743(b) — either as a result of a Section 754 election or because of a "substantial built-in loss" in the partnership's assets — would generally result in the creation of market discount as to the purchaser's proportionate share of the debt instrument.

The Discussion Draft would also provide for new broker reporting obligations with respect to includible market discount.

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7 Specifically, the total amount of includible market discount would be limited to the amount that would be determined if the holder's tax basis in the market discount bond were equal to its imputed principal amount, computed using a discount rate equal to the greater of (1) the bond's yield to maturity (determined as of the original issue date) plus five percentage points and (2) the applicable federal rate (determined as of the original issue date) plus 10 percentage points.

8 We note that some distressed debt purchasers may take the position that the current market discount rules do not apply to the acquisition of deeply distressed debt.

9 Holders that purchase bonds on a leveraged basis often elect to accrue market discount currently in order to be able to utilize the interest deductions with respect to the leverage to offset the market discount. Holders that purchase on an unleveraged basis, however, would be required to accrue the discount as ordinary income currently and would realize a capital loss upon disposition or retirement of the bonds to the extent they did not recover the full discount.

Identification Requirement for Hedging Transactions

In order for a transaction to qualify as a "hedging transaction" under Section 1221(b)(2) and Treasury regulation section 1.1221-2, the taxpayer must clearly identify the transaction as such before the close of the day on which the taxpayer acquired, originated or entered into the transaction.[10] The Discussion Draft significantly relaxes this stringent requirement for certain taxpayers that prepare audited financial statements in accordance with U.S. generally accepted accounting principles (GAAP). Under the Discussion Draft, such taxpayers would generally be deemed to satisfy the identification requirement if the transaction in question were treated as a hedging transaction under GAAP. This provision would provide welcome certainty to taxpayers who unintentionally overlook the tax identification requirements for GAAP hedges and then must rely on the "inadvertent error" provision in the hedging regulations, the scope of which is not entirely clear. All non-GAAP filers (including, apparently, all IFRS filers), however, would generally be required to meet the existing identification requirement in accordance with Treasury regulation section 1.1221-2(f). The Discussion Draft would not modify the substantive definition of "hedging transaction."

Tax Basis Averaging Required for Dispositions of Stock and Securities

The Discussion Draft would require the taxpayer to determine its tax basis in a "specified security" in accordance with the average basis method currently permitted (but not required) under Section 1012(c) for dispositions of RIC stock and stock acquired in connection with a dividend reinvestment plan.[11] As under present law, a taxpayer's tax basis would be determined on an account-by-account basis; thus, a taxpayer that owns specified securities in more than one account would generally be required to make separate basis computations for the securities held in each account. The Discussion Draft would also require a broker to use the average basis method in satisfying its basis reporting requirements under Section 6045(g).

Expansion of Wash Sale Rules

The Discussion Draft would expand the scope of the wash sale rules to acquisitions of substantially identical stock or securities by a "related party" of the taxpayer, including the taxpayer's spouse, any dependents of the taxpayer, certain controlled and controlling entities, and certain qualified plans and accounts.

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The foregoing is intended to identify a number of questions, issues and uncertainties raised by the Discussion Draft. Chairman Camp has made it clear that he is seeking comments from interested parties on the merits of his proposals as well as the circumstances in which the provisions need to be refined. We would be happy to discuss the Discussion Draft in more detail.

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10 Provided that the taxpayer satisfies the identification requirements, a hedging transaction generally includes any transaction entered into in the normal course of the taxpayer's trade or business primarily (1) to manage the risk of price changes or currency fluctuations with respect to ordinary property or (2) to manage the risk of interest rate or price changes or currency fluctuations with respect to borrowings or ordinary obligations.

11 A specified security would be defined by reference to its definition under Section 6045(g) and would include stock in a corporation, any evidence of indebtedness, and any commodities or other financial instruments that the Treasury Department determines should be subject to basis reporting.