

MEMO# 26948

January 25, 2013

Ways & Means Committee Releases Discussion Draft Provisions to Reform Taxation of Financial Products

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TO: TAX MEMBERS No. 8-13

DERIVATIVES MARKETS ADVISORY COMMITTEE No. 12-13 RE: WAYS & MEANS COMMITTEE RELEASES DISCUSSION DRAFT PROVISIONS TO REFORM TAXATION OF FINANCIAL PRODUCTS

Chairman Dave Camp (R-MI) of the House of Representatives Committee on Ways and Means has released a discussion draft outlining proposals to reform the taxation of financial products. [\[1\]](#) These proposals are based on testimony received during a December 6, 2011 joint hearing with the Senate Finance Committee, as well as input from tax practitioners, experts and commentators. The Committee is soliciting feedback on these proposals, which will be considered as part of comprehensive tax reform legislation.

The discussion draft includes several reforms intended to update and rationalize the tax treatment of financial products. Specifically, it includes the following proposals:

- **Require all Derivatives to be Marked-to-Market.** The draft aims to provide uniform tax treatment of financial derivatives by requiring taxpayers engaged in speculative financial activity to mark such derivatives to fair market value at the end of each tax year. Any mark-to-market gains or losses would be treated as ordinary. This proposal would not apply to derivatives used by taxpayers in the ordinary course of their business to hedge against price, currency, interest rate and other risks, nor would it apply to real estate transactions. The proposal would be effective for derivatives entered into after December 1, 2013.
- **Simplify Business Hedging Tax Rules.** The draft would permit taxpayers that are engaged in hedging business risks to treat transactions that are properly identified as hedges for financial accounting purposes to be treated as hedges for tax purposes. This would minimize inadvertent failures to identify a transaction as a hedge for tax purposes when a transaction otherwise satisfies all of the substantive requirements under the tax laws. The proposal would be effective for hedging transactions entered into after December 31, 2013.
- **Eliminate "Phantom" Tax Resulting from Debt Restructurings.** The draft would reform

the debt restructuring rules to eliminate cancellation-of-indebtedness income that arises when the issue price of the modified debt instrument is lower than the issue price of the original debt instrument. The proposal would provide that the issue price of the modified debt instrument generally cannot be less than the issue price of the debt instrument prior to modification. The floor on the issue price of the modified debt instrument would be reduced by any amount of actual principal that is forgiven. This 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.** The draft would require taxpayers that purchase 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 upon retirement or resale of the bond, consistent with the tax treatment of discount arising when a loan is originally made. 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, it 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. The draft also would permit taxpayers to claim “above-the-line” deductions for bonds acquired at a premium on the secondary market. This proposal would be effective for bonds acquired after December 31, 2013.
- **Require Taxpayers to Use Average Cost for All Securities.** The draft would require taxpayers who sell a portion of their holdings in substantially identical securities to determine their gain or loss by using their average basis in the securities. This proposal intends to prevent taxpayers from specifically identifying which shares have been sold and thereby “manipulating” the amount of taxable gain or loss recognized. The proposal would be coordinated with the cost basis reporting requirements so that taxpayers could continue to determine basis in their securities on an account-by-account basis. It would be effective for sales of securities occurring after December 31, 2013.
- **Close “Loophole” in the Wash Sale Rule.** Taxpayers currently can avoid the wash sale rule by directing a closely related party, such as a spouse or dependent, to acquire replacement securities, allowing the taxpayers to recognize losses currently. The draft would close this loophole by expanding the scope of the wash sale rule 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 of securities occurring after December 31, 2013.

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endnotes

[1] The [draft proposal](#), as well as the [press release](#), an [overview](#), a [summary](#), and a [technical explanation](#), can be found on the Ways and Means Committee’s website at: <http://waysandmeans.house.gov/taxreform/default.aspx>.

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