The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 30112

August 3, 2016

Draft Comments on Wyden Derivatives Proposal -- Comments Requested

[30112]

August 3, 2016

TO: TAX COMMITTEE No. 22-16
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 38-16 RE: DRAFT COMMENTS ON WYDEN DERIVATIVES PROPOSAL -- COMMENTS REQUESTED

Attached for your review are draft comments from the Institute on Senator Wyden's discussion draft on the taxation of derivatives. [1] The Institute recommends a number of changes that would make the proposal more fair and administrable for institutional investors, such as mutual funds, that use derivatives primarily for non-tax reasons.

Please provide any comments on the attached draft to me (kgibian@ici.org or 202/371-5432) by **Tuesday, August 23, 2016**.

Mark to Market

The discussion draft would require taxpayers to mark all derivatives to market on an annual basis, and any income, gain or loss would be treated as ordinary. The definition of derivative is fairly broad. First, the comments recommend that the definition of "derivative" specifically exclude securities lending, sale-repurchase transactions, and similar financial transactions. The discussion draft as currently written would exclude such transactions in the mark-to-market proposal, but only to the extent provided in regulations. We also recommend that certain other transactions and contracts be excluded from the definition of derivative, including stock purchase agreements, forward contracts on mortgage-backed securities; tender option bonds, mortgage dollar rolls, and low-exercise strike price warrants.

Second, the Institute argues that any mark-to-market income, gains or losses should have the same character as the underlying security (typically capital assets), rather than the ordinary treatment that would be mandated by the discussion draft. Providing consistent character treatment between the derivative and the underlying would be more appropriate and would prevent additional tax planning opportunities. We also note that ordinary tax treatment would create unique difficulties for regulated investment companies ("RICs"), particularly because RICs cannot carry forward net operating losses ("NOLs") under current law.

Investment Hedging Units

Senator Wyden's discussion draft contains new rules that would require taxpayers to identify certain derivatives and underlying investments as an "investment hedging unit," or "IHU." Taxpayers would be required to mark the entire IHU to market annually, and any income, gain or loss would be ordinary. The Institute questions whether the IHU regime is appropriate for taxpayers, such as RICs, that use derivatives to hedge various risks on the capital assets in their portfolios. We do not believe there is a good policy rationale for requiring taxpayers to mark all derivatives and underlying assets to market, resulting in ordinary gain or loss. We argue that a more administrable and fair regime would resemble the current rules for business hedging. Under such a regime, the character of any derivatives would match the character of the investments being hedged. Gains or losses on the derivatives would be deferred until gains or losses are recognized on the hedged assets. Such a regime would more clearly reflect the economics of derivatives used to hedge investment or portfolio risk and could resolve many of the industry's concerns with the current mark-to-market proposal.

If, however, the IHU regime is included in any future legislative proposal, the Institute recommends a number of changes to make the rules more administrable.

Overlap with the Straddle Rules

First, it appears that the IHU regime does not replace the current straddle rules, and that any derivative and underlying investment that does not qualify as an IHU still would be subject to the those rules. Given the complexity of the straddle rules, we suggest that any derivatives and underlying investment that would be an IHU but for the delta test should not qualify as a straddle. We also recommend that the Qualified Covered Call Option (QCCO) exception to the straddle rules be maintained.

Definition of Underlying Investment

The definition of "underlying investment" as currently written would exclude certain common investment hedging transactions. For example, a foreign currency forward contract and a foreign currency-denominated bond would not fall within the definition of a potential IHU. The Institute does not believe that the definition should be expanded but asks that taxpayers be permitted to treat these additional relationships as IHUs if they wish to match the timing and character of the positions.

Delta Testing

The discussion draft would characterize a derivative and an underlying investment as an IHU if the derivative has a delta relationship to the underlying investment of minus 0.7 or lower. The Institute questions whether this test is high enough and suggests that a correlation of minus 0.8 or lower (as is used in the regulations under section 871(m)) might be more appropriate.

Testing and Identification of an IHU

The discussion draft would require taxpayers to test for delta and identify potential IHUs at several specific points during the period that the taxpayer holds one or more derivatives with respect to all or part of an underlying investment. For an actively managed portfolio, these rules could require a RIC to test each position on a daily basis. The Institute recommends that taxpayers instead be required to test and identify only at the end of their

taxable year.

Multiple Underlying Investments

The discussion draft does not specify precisely how the IHU rules are intended to work when a taxpayer uses derivatives to hedge the risk on a basket of underlying stocks, *e.g.*, shorting the S&P 500 with respect to a large-cap fund. A possible solution would be a substantial overlap test similar to that currently found in the regulations under section 246. In other words, a taxpayer could have an IHU if it owns more than 70 percent of the weight of the underlying index of the derivative. We note that such a test would raise additional issues, and the Institute would be willing to assist the Senator and his staff in crafting such rules.

Recognition of Built-in Gains and Losses

Under the discussion draft, a taxpayer that enters into an IHU would be required to recognize immediately any built-in gain on the underlying investment, but not built-in loss. We believe that this one-sided treatment is unduly punitive and is not based in sound tax policy.

If a taxpayer is required to recognize any built-in gain upon entering into an IHU, then the discussion draft should specify that any such gain recognized would be capital gain, not ordinary. The discussion draft also should specify what happens to any built-in losses that are not recognized upon entering into an IHU. Another question that should be addressed is whether a taxpayer can net any built-in losses against built-in gains on all lots of an underlying investment that are part of an IHU.

Finally, the discussion draft requires taxpayers to use the first-in, first-out ("FIFO") method when determining which positions are treated as sold upon entering into an IHU. We recommend that taxpayers be permitted to choose a lot selection method that more closely aligns the timing of the derivative with the assets being hedged, provided that the taxpayer applies and properly documents a consistent policy for doing so.

Karen Lau Gibian
Associate General Counsel – Tax Law

Attachment

endnotes

[1] *See* Institute Memorandum (29970) dated June 8, 2016.