

MEMO# 30280

September 29, 2016

ICI Submits Comments on Sen. Wyden's Discussion Draft on Taxation of Derivatives

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TO: TAX MEMBERS No. 17-16

DERIVATIVES MARKETS ADVISORY COMMITTEE No. 49-16 RE: ICI SUBMITS COMMENTS ON SEN. WYDEN'S DISCUSSION DRAFT ON TAXATION OF DERIVATIVES

The Institute has submitted the attached comments on Finance Committee Ranking Member Wyden's discussion draft on the taxation of derivatives, entitled the Modernization of Derivatives Tax Act of 2016 ("MODA"). Specifically, the Institute makes the following recommendations:

- **Mark to Market of Derivatives.** Although a mark-to-market regime for derivatives may be simpler and provide more uniform treatment than current law, it presents its own potential complexities, uncertainties and irregularities. The Institute urges the Senator to weigh all the advantages and disadvantages of a mark-to-market regime, as well as other timing rules, before any changes are made. Importantly, any significant change to current law should allow for ample lead time for the Internal Revenue Service ("IRS") and Treasury Department to issue appropriate guidance and for taxpayers to implement the new regime.
- **Definition of Derivative.** The definition in the discussion draft is a reasonable starting point for defining what constitutes a "derivative." The Institute believes, however, that a few changes should be made to exclude certain investments that typically are not, and should not be, considered derivatives. We also recommend that the IRS have discretion not only to add additional types of investments to the definition, but to exclude others as appropriate. This would permit flexibility in the new rules to respond to new investment products and issues as they develop.
- **Ordinary Treatment.** Any mark-to-market gains from derivatives should have the same character as the underlying security. Consistent treatment would limit planning opportunities and resolve several fund-specific problems that would arise if all mark-to-market gains were treated as ordinary. If ordinary character is retained, then current law should be amended to permit regulated investment companies ("RICs") to

carry forward net operating losses (“NOLs”) indefinitely.

- **Investment Hedging Units.** The Institute believes that the IHU regime, as drafted, would not achieve the simplification that Senator Wyden is seeking. Instead, we urge the Senator to consider a capital or investment hedging regime that mirrors the business hedging regime already in place under section 1221. Such a regime would more clearly reflect income resulting from investment hedging by permitting taxpayers to properly align the timing and character of derivatives with the underlying securities that they are hedging. This is particularly true for taxpayers like funds that use derivatives to manage investment risk on a portfolio-wide basis.

If the Senator does not agree that such a regime is appropriate for investment hedging, then we recommend several changes to ensure that the IHU regime does not create for taxpayers additional burdens and uncertainties in terms of tax law compliance. Thus, we recommend that the discussion draft more clearly delineate the interaction of the IHU rules and the existing straddle regime. It also should clarify the application of the IHU regime when a derivative is used to hedge on a portfolio-wide basis. We also recommend clarification or modification of the rules regarding (i) the treatment of built-in gains and losses; (ii) the definition of “underlying investment”; (iii) testing for delta; (iv) the availability of the IHU election; (v) identification of IHUs and positions that do not constitute an IHU; and (vi) the treatment of pass-through entities.

- **Embedded Derivatives.** The Institute believes that the proposal for embedded derivatives is overly broad and adds significant complexity to current law. Bifurcating an instrument into a derivative and non-derivative would raise a number of challenges, including valuation and lack of systems capabilities. It also could create significant book-tax differences. We thus urge the Senator to revise the proposal to more narrowly target those instruments about which he is most concerned.

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[Attachment](#)