

MEMO# 27183

April 15, 2013

ICI Comments on Ways & Means Committee Discussion Draft on Taxation of Financial Products

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TO: TAX MEMBERS No. 17-13

FEDERAL LEGISLATION MEMBERS No. 2-13

ACCOUNTING/TREASURERS MEMBERS No. 12-13

DERIVATIVES MARKETS ADVISORY COMMITTEE No. 30-13 RE: ICI COMMENTS ON WAYS &
MEANS COMMITTEE DISCUSSION DRAFT ON TAXATION OF FINANCIAL PRODUCTS

The Institute has submitted the attached comments to the U.S. House of Representatives Committee on Ways & Means. These comments address proposals made by the Committee in a discussion draft suggesting ways to reform the taxation of financial products. [\[1\]](#) Specifically, the Institute's comments focus on the two proposals of the most interest to the industry: (1) A proposal to mark all derivatives (defined broadly) to market annually, resulting in ordinary gains and losses; and (2) a proposal to require all taxpayers, including funds and their shareholders, to use the average cost method for determining basis.

The first proposal would require mark-to-market treatment for all derivatives. In general, the Institute believes that funds and their investors benefit from more uniform tax treatment of derivatives, given the complexity of this area of law. It is not clear, however, that a mark-to-market regime is the correct tax treatment, in light of the number of issues the proposal raises. These issues include:

- The definition of "derivative" is too broad and should be narrowed. As currently written, the proposal would include securities lending transactions, convertible debt, and American Depositary Receipts, among others, for which mark-to-market is not appropriate.
- The treatment of the mark-to-market gains and losses should be tied to the character of the underlying asset. Treating the mark-to-market gains and losses as ordinary results in differences between the character of the derivative and the underlying security, creating additional tax planning opportunities. If mark-to-market gains and losses are ordinary, funds will need the ability to carry forward NOLs, which they cannot do under current law.
- The straddle rules, if incorporated into a new regime, must be clarified and simplified.

These rules already are complicated and unclear, giving rise to inconsistent treatment. Concerns regarding the straddle rules could be significantly ameliorated by a new exception for investment or portfolio hedges, comparable to that already provided for business hedges.

The Institute's comments also address the proposal to require all taxpayers to use the average cost method for determining cost basis. This proposal would apply to both stock and debt. The Institute argues that requiring all shareholders to use the average cost method would provide little benefit, in terms of simplification or compliance. Rather, it would place substantial burdens on taxpayers and reporting brokers (including funds) who must report cost basis information under current law. The Institute's comments make the following points:

- Although theoretically simple, average cost is difficult to apply, particularly as all tax adjustments in the Internal Revenue Code are made at the individual lot level.
- Brokers and funds began reporting cost basis on equities and fund shares in 2011 and 2012, respectively, as required by law. Changing the rules again will not increase taxpayer compliance and will only create additional shareholder confusion.
- Requiring the use of average cost creates significant complexities and burdens in the context of actively traded portfolios, particularly with respect to debt. It is not clear how the average cost proposal should be applied with respect to other tax rules, such as market discount and premium, which are applied on a lot-by-lot basis.
- Mutual funds currently do not have systems capable of calculating average cost with respect to their portfolios. Until such systems are created, any average cost calculations would have to be done manually, leading to significant possibilities for errors.
- If mandatory average cost is implemented, it must apply prospectively only. Shareholders and brokers likely do not have all the information necessary to calculate average cost for pre-effective date shares.
- Brokers and taxpayers will need significant lead time to build and implement systems to calculate and report average cost. Thus, any such proposal should allow two to three years from enactment before becoming effective.

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[Attachment](#)

endnotes

[1] See Institute [Memorandum](#) (26948) dated January 25, 2013.