The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 29974

June 9, 2016

Wyden Discussion Draft on Taxation of Derivatives

[29974]

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TO: ACCOUNTING/TREASURERS COMMITTEE No. 11-16
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 28-16 RE: WYDEN DISCUSSION DRAFT ON TAXATION OF DERIVATIVES

Senator Ron Wyden (D-Or), Ranking Member on the Senate Finance Committee, recently released a discussion draft to modernize the tax treatment of derivatives, entitled the "Modernization of Derivatives Tax Act of 2016" (the "MDTA"). [1] Generally, as described below, the MDTA would apply one timing rule (mark to market), one character rule (ordinary) and one sourcing rule (taxpayer's country of residence) to all derivative contracts. It also would introduce a new capital hedging regime.

Definition of Derivatives

"Derivatives" would be defined in new section 493 and would mean any contract (including any option, forward contract, futures contract, short position, swap or similar contract) the value of which, or any payment or other transfer with respect to which, is directly or indirectly determined by reference to one or more of the following:

1. Any share of stock in a corporation;
2. Any partnership or beneficial ownership interest in a partnership or trust;
3. Any evidence of indebtedness;
4. Any real property, except when such contract requires physical delivery;
5. Any commodity that is actively traded within the meaning of section 1092(d)(1);
6. Any currency;
7. Any rate, price, amount, index, formula or algorithm; and
8. Any other item as the Secretary may prescribe.

The term "derivative" would not include, for this purpose: any contract that is part of a hedging transaction under section 1221; rights under securities lending, sale-repurchase and similar financing transactions; options received in connection with the performance of services under section 83(e)(3); insurance, annuity or endowment contracts issued by an insurance company to which subchapter L applies; any derivative with respect to stock issued by any member of the same worldwide affiliated group; or commodities used in the normal course of trade or business.

The new rules also would include special rules for contracts with embedded derivatives. If a contract can be broken down into a derivative and a non-derivative component, then each derivative component would be treated as a derivative under these new rules. If a contract has both derivative and non-derivative components but the derivative component cannot be separately valued, then the entire contract would be treated as a derivative.

New section 493 would clarify that a debt instrument would not be treated as having a derivative component simply because either (i) the debt instrument is denominated in a nonfunctional currency, or (ii) payments with respect to the debt instrument are determined by reference to the value of a nonfunctional currency. Also, American depository receipts and similar instruments with respect to shares of stock in foreign corporations would be treated as shares of stock in such foreign corporations, not as derivatives under these rules.

Taxation of Derivatives

New section 491 would set forth one set of rules for the tax treatment of derivatives. The proposal would supersede a number of existing provisions, requiring taxpayers to mark all derivatives to market annually. Specifically, it would provide that gain or loss would be recognized and taken into account in the taxable year in which a "taxable event" occurs with respect to a derivative. A "taxable event" would occur upon the termination or transfer of a derivative, and upon the close of any taxable year if the taxpayer has obligations or rights with respect to that derivative. All gains and losses resulting from such taxable events would be treated as ordinary income or loss. Further, any income or loss would be treated as derived from sources within the taxpayer's country of residence.

In determining the amount of income or gain to be recognized, the taxpayer would be permitted to rely upon a valuation provided by a broker under section 6045(b) or determined under an "applicable financial statement." An applicable financial statement generally would be a financial statement prepared in accordance with generally acceptable accounting principles and which is required to be filed with the Securities and Exchange Commission ("SEC"). If no such filing is required, an applicable financial statement could be an audited financial statement or other financial statement required to be filed with another regulatory or governmental body, including certain statements made on the basis of international financial reporting standards and filed with an agency of a foreign government that is equivalent to the SEC.

Payments in connection with a derivative (other than an option or in connection with a taxable event) would be taken into account at the time of the payment. The character and sourcing rules that apply to derivatives similarly would apply to any payments on such derivatives, *i.e.,* generally ordinary income and sourced to the residence of the taxpayer.

Investment Hedging Units

New section 492 would provide a new regime for capital asset hedging. A taxpayer would be treated as holding an "investment hedging unit" or "IHU" with respect to an underlying investment if there is one or more derivative contracts associated with one or more underlying investments having a delta between minus 0.7 and minus 1.0 during the "applicable hedging period." An applicable hedging period would be a continuous period during which the taxpayer holds one or more of the derivatives with respect to the underlying investment and one or more portions of the underlying investment.

A taxpayer would be required to identify each derivative and the portion or all of any underlying investment that make up an IHU. A taxpayer also would be required to identify those derivatives and portions of an underlying derivative that do not constitute an IHU (because the delta falls outside the required range). A taxpayer would be required to make such identifications when the positions are first established, and whenever the taxpayer either (i) enters into another derivative with respect to the underlying investment or acquires an additional amount of such underlying investment; or (ii) terminates or transfers one or more derivatives with respect to the underlying investment or sells or exchanges any portion of the underlying investment. An identification would be timely made if a taxpayer clearly makes the required identifications before the close of the day on which the identification is required, or such other time as prescribed by regulations or other guidance.

The MDTA would define "delta" as the ratio of the expected change in the fair market value of the derivative to any change in the fair market value of the underlying investment. The draft would require delta to be determined in a commercially reasonable manner that is consistent with the manner used by the taxpayer or the taxpayer's broker for purposes of applicable financial statements. Delta would be determined whenever a taxpayer is required to make an identification of a derivative and/or underlying investment.

Under new section 491, a taxpayer would be required to mark to market all derivatives and underlying investments that are part of the same IHU at: (1) the establishment of the IHU; (2) the termination or transfer of any derivative that is part of the IHU; (3) the sale or exchange of all or any portion of any underlying derivative; (4) any modification of the IHU; (5) if an IHU election is in place, the close of each business day; and (6) the close of any taxable year if the applicable hedging period with respect to the IHU of any other taxpayer (*i.e.,* a related party or flow-through entity) includes such taxable year-end.

When a taxpayer first enters into an IHU, new section 491 would require the taxpayer to recognize any built-in gain but would not allow recognition of any built-in loss. The determination of which portions of an underlying investment have been sold or exchanged in a taxable event would be made on a first-in, first-out basis, unless the taxpayer has elected to use average cost for the underlying investment.

New section 492 contains a special IHU election, which the section-by-section explanation describes as an attempt to minimize compliance burdens for taxpayers. Under this provision, a taxpayer could elect with respect to any underlying investment to treat all derivatives with respect to the underlying investment, and the underlying investment itself, as part of an IHU. The election would apply to all derivatives with respect to the underlying investment and all of the underlying investment held at any time after the election is made, including during any period that the two are not held simultaneously. It would be irrevocable. A taxpayer who fails to timely test and identify derivatives with respect to an underlying investment would be treated as having made such an election. Such a deemed election could be revoked only with the consent of the Secretary.

Any derivative or underlying investment held by a related party, as defined by section 1092(d)(4)(B) (*i.e.,* a spouse or a member of a consolidated group), would be treated as held by the taxpayer. If part or all of the income, gain, loss or expense with respect to a derivative or underlying investment held by a partnership or other flow-through entity would properly be taken into account by the taxpayer, then such derivative or investment would be treated as held by the taxpayer.

Effect on Existing Provisions

The MDTA would repeal nine code sections:

1. Section 1233, Gains and Losses from Short Sales;
2. Section 1234, Options to Buy or Sell;
3. Section 1234A, Gains or Losses from Certain Terminations;
4. Section 1234B; Gains or Losses from Securities Futures Contracts;
5. Section 1236, Dealers in Securities;
6. Section 1256, Section 1256 Contracts Marked to Market;
7. Section 1258, Recharacterization of Gain from Certain Financial Transactions;
8. Section1259, Constructive Sales Treatment for Appreciated Financial Positions; and
9. Section 1260, Gains from Constructive Ownership Transactions.

Request for Comments

Senator Wyden has requested comments on the discussion draft, as well as other topics on the taxation of financial products, by August 16, 2016. He specifically has asked for comments on: (a) whether and how to improve the definition of an embedded derivative; and (b) whether and how to include additional reporting, such as under section 6045, from dealers and financial institutions.

The Institute plans to submit comments discussing how the proposals would affect regulated investment companies ("RICs") and their shareholders. Therefore, please provide any comments on the discussion draft to me (202-371-5432 or kgibian@ici.org) no later than Friday, July 1, 2016.

Karen Lau Gibian
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endnotes

[1] The text of the discussion draft can be found here. A section-by-section explanation of the discussion draft can be found here, and the Joint Committee on Taxation's technical explanation can be found here.