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COMMENT LETTER

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ICI Letter to Treasury and IRS on Proposed Mark-to-Market Election for Section 988 Transactions (pdf)

By Electronic Delivery March 20, 2018 Douglas L. Poms Marjorie Rollinson International Tax Counsel Associate Chief Counsel (International) US Department of the Treasury Internal Revenue Service 1500 Pennsylvania Avenue, NW 1111 Constitution Avenue, NW Washington, DC 20220 Washington, DC 20224 RE: Proposed Regulations under Section 988 and Mark-to-Market Method of Accounting for Section 988 Transactions Dear Mr. Poms and Ms. Rollinson: The Investment Company Institute1 and its members support the mark-to-market election provided for section 988 transactions (the "Mark-to-Market Election") by the recently proposed regulations.2 To enhance the administrability and usefulness of the election, we request three clarifications that will provide mutual funds with the certainty and consistency that they need. We believe that applying the proposed regulations in this manner would be appropriate absent additional guidance, but confirmation by the government would be welcome. Specifically, we ask the Treasury Department and the IRS to clarify in the final regulations: 1) The application of the netting rule of section 988(b) and Treas. Reg. § 1.988-2(b)(8), by including the examples suggested below (or similar examples reflecting the same principles); 2) That the straddle rules are inapplicable (or otherwise without effect) when a taxpayer that makes the Mark-to-Market Election has one or more section 988 transactions that diminish currency risk on one or more other section 988 transactions; and 1 The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$22.5 trillion in the United States, serving more than 100 million US shareholders, and US$7.5 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC. 2 REG-119514-15, 82 FR 60135, December 19, 2017. ICI Letter March 20, 2018 Page 2 of 10 3) That the Mark-to-Market Election can be applied with respect to the full amount of section 988 gain or loss on all section 988 transactions held during or following the taxable year in which the Mark-to-Market Election is made (the "Election Year"). In addition, we, like other taxpayers, understand the "Applicability Dates" section of the preamble to the proposed regulations to permit taxpayers to make the Mark-to-Market Election for taxable years ending on or after December 19, 2017. The Institute recently spoke with a Treasury Department official who confirmed this understanding. Accordingly, some mutual funds may make the Mark-to-

Market Election for taxable years ending December 31, 2017 or thereafter. Background The Mark-to-Market Election is available to any taxpayer who engages in a section 988 transaction. Mutual funds thus could choose to make the election in a variety of circumstances. The election is of particular interest to mutual funds that (i) invest in a portfolio of bonds that make payments denominated in or determined by reference to a currency other than the US dollar ("foreign bonds"); and (ii) hedge the foreign currency exposure back to the US dollar. These funds generally seek to offer their shareholders a favorable return from the interest rate and credit exposure provided by the bond investments while effectively removing all (or most) of the risk that currency fluctuations will impact the fund's performance. To do so, the fund selects the individual bonds (potentially hundreds or thousands of securities) and enters into currency derivatives (most commonly, rolling one- or three-month currency forward contracts)3 to hedge the currency exposure from the foreign bonds back to the US dollar ("currency contracts"). The currency contracts and the foreign bonds generally qualify as "section 988 transactions" under section 988(c)(1). In general, the economic gain or loss experienced on the currency contracts should equal or approximate the currency-related loss or gain experienced on the foreign bonds. The investment objective of the hedging activity is to produce exactly that result. Thus, the funds want the tax consequences of the hedging activity to reflect an alignment of the timing of recognition with respect to the hedged transactions (generally the currency exposure in the foreign bonds) and the hedging transactions (generally the currency contracts). This also is rational from a tax policy standpoint. In the absence of a special tax accounting method, however, the timing of recognition on the currency contracts generally will not align with the timing of recognition on the bonds in these funds. Gain or loss is recognized on the currency contracts as they expire or "roll" at the end of, for instance, each one-month or three-month period (and, to the extent that the currency contracts constitute section 1256 contracts, at taxable year-end). Gain or loss, including currency-related exchange gain or loss with respect to principal, is recognized on the bonds at disposition, which could take any number of years. If the straddle rules of section 1092 apply,4 3 Foreign currency futures or options also may be used. 4 It is not certain whether or when a short currency contract on a particular currency creates a straddle with a bond denominated in that same currency. While the short currency contract diminishes the currency risk associated with ICI Letter March 20, 2018 Page 3 of 10 they may address some of these timing differences by causing loss realized on a currency contract to be deferred against unrealized gain on an associated bond. That result, however, falls well short of the desired alignment between economics and tax treatment of the currency hedging.5 Some fully currency-hedged mutual funds have addressed these timing issues by requesting and receiving private letter rulings under Treas. Reg. § 1.988-5(e).6 As described in more detail in these private letter rulings, these funds treat their currency contracts as an aggregate hedge of the currency exposure in the bond positions and effectively defer their net realized foreign currency gain or loss to the extent of offsetting net unrealized foreign currency loss or gain. This approach, if available, effectively aligns the timing of recognition on the hedging transactions with the timing of recognition on the hedged position, causing net realized gains or losses on the currency contracts (or bonds) to be deferred to the extent of offsetting unrealized losses or gains on the bonds. Accordingly, it reflects the economics of the hedging transactions. Requiring companies to seek a private letter ruling each time they launch one of these types of funds, however, is not desirable for either the mutual fund industry or the government. The Mark-to-Market Election provides an alternative for these funds and their shareholders to achieve tax results that are consistent with the economics of the currency hedging. We thus commend the Treasury Department and the IRS for permitting taxpayers to utilize this election immediately.7 the bond, it does not reduce the interest rate risk or the credit risk on the

bond. Thus, the determination of whether the risk reduction constitutes a “substantial diminution” of the risk of loss is a fact-specific and subjective question. 5 The straddle rules (to the extent applicable) could cause realized losses on the currency contracts to be deferred against unrealized gains on the bonds, but would not cause realized gains on the currency contracts to be deferred against unrealized losses on the bonds; therefore, they do not provide for general alignment in timing of recognition. The straddle rules also may cause realized losses on the currency contracts to be deferred against the overall unrealized gain in the bonds, not just gain on the currency exposure that is being hedged. In addition, the straddle rules could cause holding periods in bonds to be forfeited in certain circumstances, even though the holding period is relevant only to the portion of the bond exposure that is unhedged (i.e. the market gain or loss). 6 See PLR 201704013; PLR 201728003. 7 We also commend the Treasury Department and the IRS for expanding the scope of the hedge timing rules of Treas. Reg. § 1.446-4, which generally provide for gain or loss from a hedging transaction to be taken into account at the same time as the gain or loss from the item being hedged. By expanding the scope of the hedging transactions that are eligible for these hedge timing rules to “bona fide hedging transactions” (as defined in Treas. Reg. § 1.954- 2(a)(4)(ii)), the proposed regulations seem to permit taxpayers to apply the hedge timing rules for currency contracts that hedge the currency risk on bonds held as capital assets. Taxpayers thus may utilize a tax accounting method similar to that authorized in the private letter rulings described above without the need for a ruling under Treas. Reg. § 1.988-5. This approach arguably already is permitted under section 1221(b), because the foreign-currency- receivable component of the bond could be viewed as the hedged ordinary property necessary for section 1221(b) to apply. Uncertainty with regard to this position, however, has caused some taxpayers to seek private letter rulings, and clarification that those rules are available is very much welcome. ICI Letter March 20, 2018 Page 4 of 10 Interaction Between the Mark-to-Market Election and the “Netting Rule” of Section 988(b) and Treas. Reg. § 1.988-2(b)(8) Section 988(b) and Treas. Reg. § 1.988-2(b)(8) provide that section 988 gain or loss recognized on the disposition of a debt instrument is limited to the overall gain or loss realized on the transaction (the “Netting Rule”). Prop. Reg. § 1.988-7(a) provides that a section 988 transaction subject to the Mark-to-Market Election is not subject to the Netting Rule in taxable years prior to the taxable year in which exchange gain or loss would be recognized but for the Mark-to-Market Election. This statement in Prop. Reg. § 1.988-7(a) seems to indicate two things. First, it clearly indicates that in calculating the section 988 gain or loss recognized on a debt instrument because of a mark made at the close of a taxable year prior to the year in which the bond is disposed, the full amount of section 988 gain or loss is recognized regardless of the overall gain or loss on the transaction to that point. Second, it indicates that in calculating section 988 gain or loss in the taxable year in which the debt instrument is disposed, the Netting Rule is applicable and thus applies to limit section 988 gain or loss recognized to the overall gain or loss realized on the transaction (with “appropriate adjustments” made for section 988 gain or loss previously recognized as a result of prior marks). We believe that the Netting Rule (and the appropriate adjustments in respect of prior marks) should be applied at disposition in a manner that ensures that the net section 988 gain or loss recognized over the life of the section 988 transaction equals the section 988 gain or loss that would have been recognized on that transaction in the absence of the Mark-to-Market Election. This approach ensures that the Mark-to-Market Election is purely a timing rule, not a character rule, and is consistent with the statutory requirement that section 988 gain or loss be limited to the overall gain or loss on the transaction. Although we believe the proposed regulations are appropriately interpreted in this manner, we recommend that the final regulations include the following examples to provide clarity on this point. Example 1. X, a taxpayer with the dollar as its functional currency, makes the

Mark-to-Market Election for its taxable year ending December 31, 2017. On January 1, 2017, X pays €100,000 for a debt instrument. The spot rate on January 1, 2017 is €1 = $1.00. The terms of the debt instrument provide that the issuer will make interest payments of €50 on December 31 of 2017, 2018 and 2019, and will repay the €100,000 of principal on December 31, 2019. X sells the bond on December 31, 2017 for €99,000 after the interest payment. The spot rate on December 31, 2017 is €1 = $1.04. X's exchange gain on the €100,000 of principal is $4,000 [(€100,000 x $1.04) – (€100,000 x $1.00)]. This exchange gain, however, is only realized to the extent of the total gain on the transaction. X's total gain is $2,960 [(€99,000 x $1.04) – (€100,000 x $1.00)]. Thus, X will realize $2,960 of exchange gain (and will realize no market loss) on the transaction. Example 2. The facts are the same as in Example 1, except X does not sell the ICI Letter March 20, 2018 Page 5 of 10 bond on December 31, 2017. Instead, X sells the bond on January 1, 2018 for €99,000. The spot rate on January 1, 2018 is €1 = $1.05 On December 31, 2017 (the last day of X's taxable year), X will recognize exchange gain on the debt instrument on a mark-to-market basis determined without regard to the Netting Rule. X's exchange gain on the €100,000 of principal is $4,000 [(€100,000 x $1.04) – (€100,000 x $1.00)] as of December 31, 2017. Although X's total gain as of December 31, 2017 is only $2,960 [(€99,000 x $1.04) – (€100,000 x $1.00)], the Netting Rule does not apply. Thus, X will realize $4,000 of exchange gain on December 31, 2017. When X sells the debt instrument on January 1, 2018, the Netting Rule applies. Setting aside the prior mark, X's exchange gain on the €100,000 of principal is $5,000 [(€100,000 x $1.05) – (€100,000 x $1.00)]. This exchange gain, however, is only realized to the extent of the total gain on the transaction. X's total gain is $3,950 [(€99,000 x $1.05) – (€100,000 x $1.00)]. Thus, X should realize $3,950 of exchange gain (and no market loss) with respect to the transaction. X realized $4,000 of exchange gain on the December 31, 2017 mark. Appropriately adjusting for that prior recognition, X realizes $50 of exchange loss (and no market loss) on the January 1, 2018 sale such that X's net exchange gain or loss recognized over the life of the transaction ($3,950) equals the exchange gain or loss that X would have recognized but for the Mark-to-Market Election. Example 3. The facts are the same as Example 2 except that on December 31, 2017 the value of the debt instrument is €98,000 and the spot rate €1 = $1.02 and on January 1, 2018 X sells the debt instrument for €97,000 and the spot rate is still €1 = $1.02. On December 31, 2017 (the last day of X's taxable year), X will recognize exchange gain on the debt instrument on a mark-to-market basis determined without regard to the Netting Rule. X's exchange gain on the €100,000 of principal is $2,000 [(€100,000 x $1.02) – (€100,000 x $1.00)] as of December 31, 2017. Although X has an overall loss $40 [(€98,000 x $1.02) – (€100,000 x $1.00)] as of December 31, 2017, the Netting Rule does not apply. Thus, X will realize $2,000 of exchange gain on December 31, 2017. When X sells the debt instrument on January 1, 2018, the Netting Rule applies. Setting aside the prior mark, X's exchange gain on the €100,000 of principal is $2,000 [(€100,000 x $1.02) – (€100,000 x $1.00)]. This exchange gain, however, should only be realized to the extent of the total gain on the transaction. X has an overall loss of $1,060 [(€97,000 x $1.02) – (€100,000 x $1.00)]. Thus, X should realize $0 of exchange gain or loss and $1,060 of market loss with respect to the transaction. X realized $2,000 of exchange gain on the December 31, 2017 mark. Appropriately adjusting for that prior recognition, X realizes $2,000 of exchange loss and $1,060 of market loss on the January 1, 2018 sale such that X's net exchange gain or loss recognized over the life of the transaction ($0) equals the ICI Letter March 20, 2018 Page 6 of 10 exchange gain or loss that X would have recognized but for the Mark-to-Market Election. Interaction Between the Mark-to-Market Election and the Straddle Rules of Section 1092 In the absence of the Mark-to-Market Election (or the hedging rules of section 1221(b) or Treas. Reg. § 1.988-5), a short currency contract and a long position in a bond denominated in the same currency may constitute a

straddle.8 If the straddle rules apply, losses realized on short currency contracts would be deferred to the extent of unrealized gain (i.e., overall gain, not just currency-related gain) on the corresponding bonds. In addition, the holding period of the bonds may be forfeited in certain circumstances. If the Mark-to-Market Election is made, the straddle rules should not apply to the bonds and the currency contracts. In that case, the currency contracts and the currency components of the bonds would be marked to market.9 Since the same timing rules would apply to those offsetting components of the bonds and the hedge, there should be no need for straddle consequences. Further, the change in value of the currency contract due to changes in exchange rates is unrelated to, and therefore does not substantially diminish, the risk of loss with respect to the change in value of a bond due to interest or credit changes.10 If the straddle rules were applied notwithstanding the Mark-to-Market Election, the results would be anomalous. For example, assume that a taxpayer holds a foreign bond and a short currency forward hedging the currency risk on the bond. As of taxable year-end, the currency forward has depreciated in value by $2 and the bond has appreciated by $8; $2 of the appreciation on the bond is attributable to exchange gain, and $6 of the appreciation on the bond is attributable to market appreciation (e.g., interest rate movements). The Mark-to-Market Election would result in the realization of the $2 loss on the currency forward and the $2 of exchange gain on the bond, thereby aligning the timing of recognition on the hedging transaction with the exposure being hedged. If the $2 loss realized on the currency forward is deferred under the straddle rules due to the existence of $6 of unrealized gain on the bond (i.e., the market appreciation), the alignment of timing of recognition and consistency with economics is lost. The $2 of loss realized on the currency forward has no relationship to the $6 of market 8 See note 4 above. 9 As noted earlier, some currency contracts may be section 1256 contracts. Under Prop. Reg. § 1.988-7(b), these contracts technically are not subject to the Mark-to-Market Election because they already are marked to market under section 1256. The Mark-to-Market Election would cause the bonds and any currency contracts that aren’t subject to section 1256 (or any other mark-to-market regime) also to be marked to market. 10 The bond, however, might still constitute a straddle with another offsetting instrument in a fund’s portfolio. For instance, a fund’s portfolio manager may use short bond futures to hedge a bond’s market risk. For foreign bonds, a fund’s portfolio manager may hedge both market and currency risks of foreign bonds. If a fund has made the Mark- to-Market Election, the straddle rules would not apply to the currency contracts and the foreign bonds, but could still apply to the bond futures and the bonds to the extent they constitute offsetting positions. ICI Letter March 20, 2018 Page 7 of 10 appreciation, and thus there is no need for any straddle deferral.11 Similarly, no other straddle consequences should apply under the circumstances. For example, the holding period should be unaffected as it is only relevant to the portion of the bond exposure that is unhedged (i.e., the market gain or loss). The straddle rules should be inapplicable not only as a matter of policy, but also as a reasonable interpretation of the proposed regulations and other relevant provisions. The proposed regulations provide for the Mark-to-Market Election to apply the principles of section 1256; there are no straddle consequences when you have a straddle comprised of only section 1256(g)(2) foreign currency contracts (or any other section 1256 contracts).12 In addition, the straddle rules contain exceptions for certain types of hedging transactions, which may be broad enough to encompass the scenarios discussed above.13 Although we believe that taxpayers reasonably can conclude that the straddle rules are inapplicable where one or more section 988 transactions diminish currency risk on one or more other section 988 transactions and the taxpayer makes the Mark-to-Market Election,14 we ask the government to confirm this conclusion in the final regulations.15 Transitioning into the Mark-to-Market Election An existing fund that makes the Mark-to-Market Election may confront the question of whether or how to apply the election with regard to section 988

transactions entered prior to the Election Year and still held in the Election Year ("Pre-Election Section 988 Transactions"). The 11 Even if the hedge were imperfect and, for example, there is $3 of loss realized on the forward and $2 of exchange gain realized on the bond, there still is no reason for the $1 of excess currency loss to be deferred against the unrealized market appreciation on the bond as the two components are not offsetting. 12 See Sections 1092(d)(5)(A); 1256(a)(4). 13 See Sections 1092(e); 1256(e). 14 We note that our phrasing here intentionally refers to the straddle rules as being inapplicable where a taxpayer (i) makes the Mark-to-Market Election and (ii) holds one or more section 988 transactions that diminish currency risk on or more other section 988 transactions. We recommend this wording rather than stating that the straddle rules are inapplicable where a taxpayer holds one or more section 988 transactions subject to the Mark-to-Market Election that diminish currency risk on one or more other section 988 transactions subject to the Mark-to-Market Election. Under Prop. Reg. § 1.988-7(b), the Mark-to-Market Election does not apply to section 988 transactions that already are marked to market under section 1256 or any other provision of the Code. Prop. Reg. § 1.988-7(b) presumably was included because there is no need for the Mark-to-Market Election to apply to transactions that already are subject to mark-to-market timing. Those section 988 transactions are intended to be within the scope of this straddle clarification, however (e.g., a currency contract that is section 1256 contract that diminishes currency risk on a foreign bond should not be subject to the straddle rules if the Mark-to-Market Election is made for the reasons discussed above). Therefore, we believe the wording we have suggested is appropriate. 15 We recognize that the tax law generally does not weigh in favor of bifurcation of an instrument into its component parts, including in applying the straddle rules. The section 988 and related Treasury regulations, including Prop. Reg. § 1.988-7, however, already effectively bifurcate foreign currency gain or loss on section 988 transactions from any other gain or loss recognized on the transactions. Therefore, we do not believe that this general policy against bifurcation should be of concern to the government in confirming that the straddle rules do not apply as described above. ICI Letter March 20, 2018 Page 8 of 10 proposed regulations do not address whether or how the Mark-to-Market Election applies to these transactions. Three approaches seem possible. First, the Mark-to-Market Election could apply only to section 988 transactions entered into during or following the Election Year, in which case the Pre-Election Section 988 Transactions would not be subject to the election. Second, the Mark- to-Market Election could apply to all section 988 transactions held during or following the Election Year (including Pre-Election Section 988 Transactions) but only with respect to section 988 gain or loss that arises during or after the Election Year. In that case, section 988 gain or loss that is attributable to the period prior to the election year would not be included in the marks and thus would be deferred until disposition. Third, the Mark-to-Market Election could apply to the full amount of section 988 gain or loss on all section 988 transactions held during or following the Election Year (including Pre-Election Section 988 Transactions), regardless of when that gain or loss arose. For example, assume a taxpayer makes the Mark-to-Market Election for the taxable year ending December 31, 2017. As of December 31, 2016, the taxpayer held a bond with total unrealized gain of $10, consisting of $6 of exchange gain and $4 of market gain. As of December 31, 2017, the taxpayer still held the bond and the total unrealized gain was $13, consisting of $8 of exchange gain and $5 of market gain. Under the first approach described above, this bond would not be subject to the Mark-to-Market Election because it was acquired prior to the Election Year. Thus, no section 988 gain or loss would be recognized on the bond on December 31, 2017. Under the second approach, the bond would be subject to the Mark-to- Market Election but the taxpayer would only recognize $2 of section 988 gain on the December 31, 2017 mark (i.e., the difference between the $6 of exchange gain as of December 31, 2016, and the $8 of exchange gain as of December 31,

2017.) Presumably the $6 of unrealized exchange gain attributable to the period before the Election Year would be deferred until disposition. Under the third approach, the bond would be subject to the Mark-to-Market Election, and the taxpayer would recognize the full $8 of section 988 gain on the December 31, 2017 mark. For administrative ease, we recommend that taxpayers be permitted to utilize the third approach. Accordingly, the Mark-to-Market Election would apply to the full amount of section 988 gain or loss on all section 988 transactions held during or following the Election Year (including section 988 gain or loss attributable to the period prior to the Election Year on Pre- Election Section 988 Transactions). Further, Prop. Reg. § 1.988-7(a) provides that the election is made by including a statement with the taxpayer's tax return, indicating that a Form 3115 (Application for Change in Accounting Method) is not required. We recommend that the final regulations confirm this point. We also recommend that the final regulations clarify that no section 481(a) adjustment is required in addition to the section 988 gain or loss recognized for the Election Year. Although we believe it is reasonable for taxpayers to apply the proposed ICI Letter March 20, 2018 Page 9 of 10 regulations in this manner, we recommend that the Treasury Department and IRS confirm these points in the final regulations. Recommendations The Institute believes that it would be appropriate to apply the proposed regulations in the manner described above, but we would appreciate confirmation of these points. The Institute thus asks that the final regulations: (1) Clarify the application of the Netting Rule of section 988(b) and Reg. Sec. 1.988- 2(b)(8) by including the examples suggested above (or similar examples reflecting the same principles); (2) Clarify that the straddle rules are inapplicable (or otherwise without effect) when a taxpayer that makes the Mark-to-Market Election has one or more section 988 transactions that diminishes currency risk on one or more other section 988 transactions;16 and (3) Clarify that the Mark-to-Market Election can be applied with respect to the full amount of section 988 gain or loss on all section 988 transactions held during or following the Election Year (including section 988 gain or loss attributable to the period prior to the Election Year on Pre-Election Section 988 Transactions).17 * * * 16 See note 10 above. 17 As noted, the final regulations also should confirm that a Form 3115 is not required for funds making the Mark-to- Market Election after their initial tax year and that no section 481(a) adjustment is required in addition to the section 988 gain or loss recognized for the Election Year. ICI Letter March 20, 2018 Page 10 of 10 We appreciate your attention to our request. Please do not hesitate to contact me (202- 371-5432 or kgibian@ici.org) if you have any questions. Sincerely, /s/ Karen L. Gibian Karen Lau Gibian Associate General Counsel, Tax Law cc: Chip Harter Brian Jenn William Paul Jeffery Mitchell Mark Erwin Steven Jensen Pamela Lew

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