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February 4, 2013

Ray Beeman, Esq.
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Re: Financial Products Proposal

Dear Mr. Beeman:

I am writing to offer a few initial thoughts on the Ways and Means Committee proposal to reform the taxation of financial instruments.

Chairman Camp, the other members of the Ways and Means Committee and its staff are to be commended for addressing this difficult and important subject in a thoughtful and deliberate way. Achieving greater uniformity in the tax treatment of derivatives is a particularly desirable goal. Releasing the proposal for advance comment (as was also done for the proposal to reform the international tax system) is a welcome step.

My comments relate to derivatives and market discount.

Derivatives

The proposal would subject all "derivatives" to an ordinary/mark to market regime under a new section 485. Derivatives are defined in new section 486. The main exception is for hedging transactions, as defined under current law with some greater flexibility in applying the identification requirement.

The new regime would provide uniform treatment for a broad range of derivative transactions. This letter does not comment on the basic rule, but instead focuses on its scope and some more technical concerns.

The reach of new section 485 is extremely broad in two respects. First, it covers derivative financial instruments relating to stock, debt, trust or partnership interests, certain real property and any currency without a requirement that the underlying property or the derivative be actively traded. (Derivatives on commodities are also covered but the commodities must be actively traded.) Second, it covers any position that is offsetting to a derivative under the section 1092 definition of offsetting.

This very likely goes too far. A derivative financial instrument (as defined in section 486(b)) includes a forward contract or an option. Any privately negotiated contract to buy property on a future date can be considered a forward contract. Options are common in conventional commercial transactions.

As written, the mark to market rule would cover options or contracts to buy interests in closely held partnerships or corporations. For example, a buy-sell right in a partnership agreement would appear to be an option or forward contract with respect to a partnership interest. A contract to buy a controlling stock interest in a corporation would be a forward contract on stock. The hedging transaction exception would not apply because the underlying assets would be capital assets. These arrangements are not generally thought to fall within the "financial products" world, and it is not apparent that their treatment has been particularly troublesome under current law.

Section 485 also is not coordinated with the rules governing compensatory options or other derivative contracts and would potentially apply to them.

Turning to the straddle rule, section 485(c)(1) would treat as derivatives subject to ordinary/ mark to market treatment any non-derivative position that is offsetting to a derivative (determined under the section 1092 definition of offsetting).[1]

The definition of offsetting in section 1092 is sweeping (it requires only a substantial diminution of risk of loss). The requirement in that section that a position relate to actively traded property is an important limitation on the scope of the straddle rules. Without it, new section 485 would have a reach that is uncertain and very broad.

To illustrate, multinational groups frequently enter into so-called Hoover hedges, which are foreign currency positions that hedge currency exposures with respect to equity

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[1] The rule states that "the term 'straddle' has the meaning given such term by section 1092(c) applied without regard to paragraph (2)(B) thereof and by treating all offsetting positions as being with respect to personal property". This language appears to have the effect of eliminating the requirement in section 1092(d)(1) that a straddle position relate to actively traded personal property. It also turns off the special rule for stock in section 1092(d)(3) that generally limits positions offsetting stock to those that are in the stock or in substantially similar or related property. The carve out of paragraph (2)(B) eliminates the protection of the identified straddle rules, as discussed below in the text.

investments in foreign subsidiaries. Those hedges could potentially be offsetting positions with respect to stock in the subsidiary if the value of the subsidiary is significantly influenced by foreign exchange fluctuations.[2] It surely goes too far to require stock of a foreign subsidiary to be marked to market because its parent enters into a foreign currency hedge.

As another example, consider an owner of fixed rate loans in whose hands the loans are capital assets.[3] If the owner enters into interest rate swaps to manage interest rate risk it likely would be required to mark the loans to market under section 485 unless the swaps are integrated with the loans. It can be argued that mark to market treatment for loans (outside of section 475) is desirable, but it would represent a very significant change. Many loan portfolios are hedged to some degree. If hedges were added and taken away, the effect would be to trigger mark to market gains but not allow losses.

The hedging exception to section 485 would not address these examples even though the hedges are entered into in the normal course of business because a hedging transaction requires a hedge of an ordinary asset or liability. Further, the hedging exception may not apply to derivative contracts that have a material investment component (such as potentially prepaid forward contracts) because contracts of that type are not generally considered to "manage risk" within the meaning of the hedging rules.[4]

It may be useful to compare the proposal with section 1259. That section requires gain to be recognized with respect to a constructive sale of a financial position. A constructive sale is a short or long position of a type listed in section 1259(c)(1) that offsets a financial position. Section 485 appears to operate like section 1259 in that it will require any owner of appreciated property that enters into a derivative contract that offsets the property to recognize pre-existing gain in the property.[5] There are, however, major differences in the operation of sections 485 and 1259. Most significantly, section 1259 requires an almost perfect hedge, not just an offsetting position. Also, section 1259 does not apply to conventional debt instruments (they are not financial positions). Section 1259 has an exception for a contract of sale for nonmarketable property that is closed within one year. Section 1259 provides relief for positions that are added but then taken off within 30 days after the close of the taxable year (followed by an at-risk period of 60 days).

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[2] Under current law, Hoover hedges are not subject to hedging rules under section 988(d).

[3] Banks are entitled to automatic ordinary treatment of debt instruments under section 582(c). Active non-bank lenders may be able to treat loans they originate as ordinary assets under the *Burbank Liquidating* line of authorities, but that would not apply to acquired assets or to taxpayers not in an active lending business.

[4] See Treasury regulation section 1.1221-2(d)(5) (investments in debt, equity securities and annuities generally do not manage risk).

[5] The technical explanation of section 485 states that only gain or loss accruing during the existence of a straddle will be subject to the new mark to market regime. However, that appears to refer to the requirement of annual marks and ordinary treatment. Section 485(c)(2)(A)(i) states that a non-derivative position with a built-in gain is considered deemed sold under subsection (a)(1) when the straddle is established (although the ordinary character rule in subsection (b) does not apply to resulting gain).

Relying on the straddle rule definition of offsetting position is troublesome because it is hard to apply in practice. The problems may be tolerable under current law but become less so when the definition is applied to require mark to market treatment.

One of the problems with the existing straddle definition is uncertainty about how to allocate positions when there are two or more longs and one short (or two or more shorts and one long). Another well know problem is determining whether hedges of a gap between assets and liabilities are properly allocated to the asset or liability.

In applying section 1092, the identified straddle rules can help by allowing a pairing of offsetting positions through identification. However, they require planning (because offsetting positions must be identified when entered into) and are limited in scope. For example, an identified straddle must include all positions within the straddle, and it is not always easy to know what those positions are, particularly when hedging is done on a portfolio basis.

At any rate, section 485 appears to remove the protection of the identified straddle rules by applying the definition of offsetting position without regard to section 1092(c)(2)(B).

The straddle rule would effectively allow any taxpayer to adopt elective ordinary/ mark to market treatment for capital assets by maintaining a position in an offsetting derivative. That is not troublesome to me because that treatment is generally acceptable as a way of reporting income, but it is worth noting that this is an implication of the proposal.

Section 485 could be limited in a number of ways without losing the benefit of achieving uniform treatment of derivatives. It could apply only to positions in actively traded property (which might include any property that is in fact marked to market for financial statement purposes). At the least, there could be an exception for non-traded direct investments in stocks or partnerships.[6] Consideration also should be given to having an exception to the straddle rule for straight debt (similar to the exception in section 1259) or for interest rate and currency hedges of debt instruments (similar to the exception provided in the legislative history of section 901(l)).

A few other more technical points:

It is not clear how the rule in section 485(b)(1) treating gain or loss from derivatives as ordinary income relates to section 1032. Section 1032 provides that a corporation does not recognize gain or loss from transactions in its own stock. The section applies by its terms to options, and it also has routinely been applied to forward contracts in stock (included those that are cash settled).[7] The technical explanation states that the new rule overrides

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[6] By way of comparison, the dealer mark to market rules under section 475 have automatic exceptions for equity interests in related persons. See Treasury regulation section 1.475(b)-1(b) (automatic identification of such interests as held for investment). A broader exception would seem to be warranted for a mark to market regime applicable to all categories of taxpayers.

[7] See, e.g., PLRs 200450016 (August 17, 2004) and 201105030 (October 29, 2010)) and CCAs 200832022 (April 23, 2008) and 201025047 (March 22, 2010).

nonrecognition sections, but likely the drafters were thinking of sections that defer gain or loss, not ones like section 1032 that eliminate it.

The definition of derivative in section 486(a)(1) includes "any evidence of an interest in" stock, debt, etc. Because the treatment of derivatives under the proposal will differ radically from the treatment of the underlying, it is important to understand what an "evidence of an interest in" means.[8] For example, American Depositary Receipts (custody arrangements for holding foreign stocks) or pass-through certificates representing ownership interests in grantor trusts holding mortgages could be considered evidence of interests in stock or debt but presumably that is not what the drafters meant. It would be helpful to clarify that any position that is treated for federal income tax purposes as an ownership interest in the underlying asset is not a derivative.

Section 485(c)(4) would toll holding periods for any position that is part of a straddle (as defined in section 485) with a derivative. It should be made clear that this applies for purposes of determining if capital gain or loss is long or short term, but not where the Code conditions a tax benefit on meeting an at-risk holding period test, such as section 246 (dividends received deduction) and sections 901(k) and (l). Those sections have their own standards for measuring what level of risk is enough and they should not be supplanted by a section 1092 offsetting position test.[9]

The new regime would apply to transactions entered into after December 31, 2013. It would be helpful to know how the rule would apply to positions in a straddle entered into partly before and partly after that date.

Market Discount

The proposal would require current inclusion of market discount in income but cap the accrual rate at a formula amount tied to a measure of interest rates. Mechanically, the proposal would amend section 1278 to effectively treat purchase discount on a debt instrument as if it were original issue discount (OID), except that the yield used in accruing OID is capped.

Presumably, the proposal is intended to deal with market discount that arises from factors other than increases in interest rates, which would be mainly increased credit risk. As applied in that setting, the proposal is certainly helpful. It does go beyond limiting the rate of accrual of market discount under current law because it requires the current reporting of accrued amounts.

It would help to clarify the scope of the new rule as applied to severely distressed debt instruments.

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[8] The language is borrowed from section 1092(d)(2), but the need to define the term is greater when applying section 485.

[9] Thus, in the Hoover hedge example described above, presumably it was not intended to deny the parent an indirect foreign tax credit under section 901(k) on the ground that the holding period requirement of that section is not met.

The technical explanation does not explain how the new rule is coordinated with the body of law that allows a taxpayer to not accrue stated interest that is uncollectible and to recover basis first in certain circumstances.

Suppose a debt instrument is purchased at a discount and accrues stated interest that is not included in income because it is not considered to be collectible. Is it intended that the market discount would have to be accrued on the ground that it is "interest like" even though stated interest does not accrue?[10]

Also, there is a wide consensus that market discount does not accrue under current law on debt that has been accelerated at the time of purchase (or could be because of a default) on the ground that the instrument is a demand instrument to which the market discount rules do not apply (based on the legislative history of those rules). Does that exception survive?

It is worth clarifying how the yield cap (and the mechanism for accounting for recoveries) will apply to debt instruments that are purchased and accounted for as a pool.[11] There is a regime for accruing OID on a pool of loans (section 1272(a)(6)), but it does not generally eliminate the separate identity of loans in a pool.

To the extent the proposed accrual rule would overstate income because it requires accruals of discount that is unlikely to be collected, it would be desirable to have some mechanism to allow taxpayers to avoid timing and character distortions. The core idea behind the new derivatives proposal is that it is appropriate to allow taxpayers to be taxed under an ordinary/ mark to market regime without worrying too much about the particular features of a derivative. If that is the view, then perhaps it should be extended by election to taxpayers with respect to debt instruments. That way, a taxpayer facing a tax on artificial income or character mismatches could avoid them at the expense of having to report unrealized gains and having all gains be ordinary.

Another approach would be to allow to all taxpayers partial bad debt deductions under section 166 in respect of basis created through an inclusion in income under new section 1278 (even with respect to securities) that can be shown under the section 166 tests to be attributable to uncollectible amounts.[12]

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[10] Of course, it could be that interest is not collectible but principal is. A rule that limits accruals of market discount based on uncollectibility would have to require a showing of uncollectible principal.

[11] There could be a significant difference depending on whether the cap and payment recovery rule applies to individual debt instruments or to the pool. For example, a pool of consumer receivables might be purchased at a cost of 10 cents on the dollar with the expectation that some receivables will produce substantial recoveries and most will produce nothing. If the receivables are treated separately, and the accrual rule applies despite the high risk of uncollectibility, there would be accruals of income on the receivables that do not pay and gain equal to the recovered discount on receivables that are paid in full. Treating the receivables as a pool (so that collections can be offset against the aggregate basis including accrued income if the accrual rule applies) might make more sense.

[12] This would follow the approach of Revenue Ruling 2007-32.

Another area that cries out for a change in law concerns the recognition of artificial gain from modifications of debt purchased at a significant discount. The proposal would place a floor on the adjusted issue price of the modified debt in these circumstance so as to limit COD income to the issuer, but does not address the artificial gain recognized by holders. In fact the proposal would exacerbate the problem for holders by preventing the issue price from ever being determined based on fair market value. The problem can be particularly acute in circumstances where the artificial gain is ordinary and later offset with an artificial capital loss on sale.[13]

A number of commentators (including the American Bar Association) have make proposals to address the problem and they deserve serious consideration. Possible approaches include having a broader nonrecognition rule than section 354 to defer any gain from a debt exchange without an increase in principal amount, a rule allowing losses on sale of modified debt to be treated as ordinary to the extent of prior ordinary income (with respect to that instrument or predecessor instruments), or (as mentioned above) a broader elective ordinary/ mark to market regime.

I hope these few thoughts are helpful to you in refining the proposal. I would be pleased to discuss these comments or the proposal more broadly with you or your colleagues.

Very truly yours,

James M. Peaslee

2682426

[13] The problem arises often in purchases of pools of consumer receivables, so any solution should apply to obligations of natural persons.