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FINANCIAL SERVICES POLICY BULLETIN

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What to Watch from Jan. 28 to Feb. 1
Tax Reform Could Reduce Incentive to Use Derivatives

Our Washington calendar of financial policy events is at the end of this note, but first a few comments on House Ways & Means Committee Chairman Dave Camp's latest plan to limit the ability of companies to use financial instruments to minimize their tax bills.

Our View

- This is an effort at discouraging companies from using derivatives except to hedge business risk. As a result, it is negative for those that create, trade, or clear derivatives.
- This is far from enactment. So this may be a risk, but it is not an imminent threat and adoption remains an uphill fight.

Keys for Investors

- Camp's plan would force all derivatives – except those used to hedge – to be taxed annually at marked to market prices. The idea is to discourage the creation of complex derivatives that exacerbated the last crisis.
- On a macro level, this plan could produce more economic stability. That would be broadly positive. The plan would be negative, however, for those that create, clear, and trade derivatives as it could reduce the use of derivatives.
- Any plan to change the tax treatment of derivatives, debt, and equity can only happen as part of a broader corporate tax overhaul. The odds of a bigger tax package are tied to the debt limit and fiscal cliff fights. In short, this is an uphill effort.
- Do not confuse this with a transaction tax. Rep. Camp is NOT proposing to tax financial transactions like Europe is considering. This is going after transactions that are designed to limit a company's tax bill.
- Some of the downside may be offset because the proposal would simplify the hedging rules so a business hedging a risk is less likely to inadvertently incur a bigger tax burden. That could encourage more hedging, though we suspect that the margin on a business hedge is less than the margin on a complex derivative.
- Rep. Camp also would change how the government determines the tax when securities are sold. The seller would have to use his average cost basis for all similar securities he owns when calculating a gain or loss. That means the seller could no longer identify specific shares in a way that could reduce the required tax.
- The plan would also eliminate phantom taxes from debt restructurings, harmonize the tax treatment for bonds that trade at a discount or premium on the secondary market, and further crack down on the harvesting of tax losses on securities.

Copy of Official Summary

- The full draft legislation is at: http://waysandmeans.house.gov/uploadedfiles/leg_text_fin.pdf.
- The explanation of this legislative text is at: **http://waysandmeans.house.gov/uploadedfiles/final_financial_products_discussion_dated_tomorrow.pdf.**
- Below is the official summary that House Ways and Means released last week:

Summary Description of Ways and Means Discussion Draft:

Financial Products

Provide Uniform Tax Treatment of Financial Derivatives

Current Law. The current law tax treatment of gains and losses from entering into derivative transactions (e.g., futures, forward contracts, swaps, and options) is highly dependent upon the type of derivative, the profile of the taxpayer, and other factors, which can result in very different tax consequences for economically similar transactions.

Discussion Draft Proposal. In order to bring uniformity to the tax treatment of derivatives and more appropriately measure income and loss, the discussion draft generally would require all derivative positions to be marked to market at the end of each tax year so that changes in the value of the derivative result in taxable gain or loss.

- Any gains or losses from marking a derivative to market would be treated as ordinary income or loss.
- For straddles (i.e., offsetting financial positions) that include at least one derivative position, all positions in the straddle would be marked to market with ordinary income or loss treatment, including stock, debt and other financial products that otherwise would not be subject to mark-to-market treatment under this proposal.
- For purposes of determining the amount of mark-to-market gain or loss on a derivative, the proposal would provide regulatory authority to rely upon the fair market value of the derivative that the taxpayer reports for financial or credit purposes.
- The proposal would not apply to common transactions involving derivatives, such as:
  - Hedges used by companies to mitigate the risk of price, currency and interest rate changes in their business operations.
  - Real estate transactions (e.g., options to acquire real estate).
  - The proposal would repeal several tax law provisions that would be superseded by general mark-to-market tax treatment of derivatives, such as provisions that attempt to police the inconsistent tax treatment of derivatives under current law.

The proposal would be effective for derivatives entered into after December 31, 2013.

Simplify Business Hedging Tax Rules

Current Law. Taxpayers are permitted to match the timing and character of taxable gains and losses on certain hedging transactions with the gains and losses associated with the price, currency or interest rate risk being hedged. However, taxpayers can only accomplish such matching tax treatment if they properly identify the transaction as a hedge on the day they enter into the transaction. Often, taxpayers inadvertently fail to satisfy this identification requirement, even though they have properly identified the transaction as a hedge for financial accounting purposes.

Discussion Draft Proposal. The discussion draft would permit taxpayers to rely upon—for tax purposes—an identification of a transaction as a hedge that they have made for financial accounting purposes. This proposal would protect taxpayers from foot faults resulting from the hedge identification tax requirements, while preventing taxpayers from using hindsight to identify a transaction as a hedge (which is the purpose of the hedge identification tax requirements). The proposal would be effective for hedging transactions entered into after December 31, 2013.

Eliminate "Phantom" Tax Resulting from Debt Restructurings

Current Law. When the terms of an outstanding debt instrument are significantly modified, the issue price of the modified debt instrument (i.e., the principal amount of the debt instrument for tax purposes) does not necessarily equal the issue price of the debt instrument prior to modification. In particular, the issue price of the modified debt instrument can be substantially lower than the issue price of the debt instrument prior to modification if the debt instrument has lost significant value since the loan was originally made (e.g., the value of real estate or other collateral supporting the loan has declined)—even if the lender has not forgiven any actual principal owed by the borrower. The reduction in the issue price resulting from the modification of the debt instrument constitutes taxable cancellation of indebtedness income to the borrower, although the borrower still owes the same actual principal amount as was owed prior to the modification. To a significant degree, this problem has prolonged and intensified the past several economic downturns, including the recent financial crisis.

Discussion Draft Proposal. The discussion draft would eliminate the phantom taxable income problem associated with many debt restructurings by generally providing that the issue price of the modified debt instrument cannot be less then the issue price of the debt instrument prior to modification. This floor on the issue price of the modified debt instrument would be reduced by any amount of actual principal that is forgiven (which, through the operation of current law, would result in taxable cancellation of indebtedness income to the borrower in the amount of principal that is forgiven). The proposal would be effective for debt modifications that occur after December 31, 2013.

Harmonize the Tax Treatment of Bonds Traded at a Discount or Premium on the Secondary Market

Current Law. When borrowers issue debt at a discount (i.e., the loan proceeds are less than the principal amount to be repaid), both the borrower and the lender are required to deduct (in the case of the borrower) and include in income (in the case of the lender) the discount as additional interest for tax purposes over the life of the loan. When a bond that already has been issued by the borrower is subsequently purchased on the secondary market at a discount, the purchaser is required to include the discount in taxable income as additional interest but, unlike discount when a loan is initially made, this discount does not have to be included by the holder of the bond until the bond is retired or the holder resells the bond.

The amount of secondary market discount that holders must include in taxable income appears under current law to include discount associated with deterioration in the creditworthiness of the borrower, even though Congress only may have intended current law to apply to discount associated with increases in interest rates.

In the case of bonds issued or acquired at a premium (i.e., the loan proceeds are more than the principal amount to be repaid), the lender or holder of the bond may only deduct the bond premium as an itemized deduction (although the deduction is not subject to the 2-percent floor).

Discussion Draft Proposal. The discussion draft would require purchasers of bonds at a discount on the secondary market to include the discount in taxable income over the post-purchase life of the bond, rather than only upon retirement of the bond or resale of the bond by the purchaser. This proposal would make the tax treatment of secondary market discount consistent with the tax treatment of discount arising when a loan is originally made.

However, the proposal also would limit taxable secondary market discount to the amount that reflects increases in interest rates since the loan was originally made. Specifically, the proposal would limit this amount to the greater of (1) the original yield on the bond plus 5 percentage points, or (2) the applicable Federal rate plus 10 percentage points.

In addition, the proposal would allow taxpayers to claim “above-the-line” deductions for bonds acquired at a premium on a secondary market. The proposal would be effective for bonds acquired after December 31, 2013.

Increase the Accuracy of Determining Gains and Losses on Sales of Securities

Current Law. When a taxpayer purchases shares of a particular company (or other substantially identical securities) at multiple times and at different prices, and later sells some (but not all) of these shares, the taxpayer is permitted to specifically identify which shares have been sold. Even though the shares are substantially identical, current law allows taxpayers to manipulate the amount of taxable gain or loss by identifying which shares have been sold based upon their basis (i.e., the amount paid by the taxpayer to purchase those particular shares).

Discussion Draft Proposal. The discussion draft would require taxpayers who sell a portion of their holding in substantially identical securities to determine their taxable gain or loss based on the taxpayer’s average basis in the securities, including both the securities sold and the securities retained by the taxpayer. This proposal would be coordinated with the recently enacted basis reporting requirements so that taxpayers would continue to be permitted to determine basis in their securities on an account-by-account basis. The proposal would be effective for sales of securities occurring after December 31, 2013.

Prevent the Harvesting of Tax Losses on Securities

Current Law. For decades, the so-called “wash sale” tax rules have prevented taxpayers from artificially creating tax losses on securities that have declined in value by selling the securities at a loss and, within a short time before or after the sale, acquiring the same (or substantially identical) securities. When these rules apply, the loss is deferred until the replacement securities are later sold. However, many taxpayers can avoid the wash sale rules fairly easily by directing a closely related party, such as a spouse or dependent child, to acquire the replacement securities.

Discussion Draft Proposal. The discussion draft would close this loophole by expanding the scope of the wash sale rules to include acquisitions of replacement securities by certain closely related parties, including spouses, dependents, controlled or controlling entities (such as corporations, partnerships, trusts or estates), and certain qualified compensation, retirement, health and education plans or accounts. The proposal would be effective for sales or securities occurring after December 31, 2013.

Washington Financial Calendar: Jan. 28 to Feb. 1

<u>Monday, Jan. 28</u>

The National Association of Realtors at 8:30 a.m. releases **pending home sales** for December.

The House is on **recess** this week while the Senate today could complete action on Hurricane Sandy relief legislation.

Tuesday, Jan. 29

The **FOMC** begins a two-day monetary policy meeting.

The Case-Shiller **home price index** for November is out at 9 a.m.

Wednesday, Jan. 30

The **FOMC** at 2:15 p.m. releases its monetary policy statement.

Friday, Feb. 1

The SEC Advisory Committee on Small and Emerging Companies meets at 9:30 a.m.

Failure Friday activity tends to slow down as the first month of each quarter comes to a close.

All times in the calendar are eastern time.