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The Harder They Come: An Overview of Financial Instrument and Institution Provisions in the Ways & Means 2014 Tax Reform Proposals

By Mark Leeds[1]

There are a lot of lost causes in the federal income tax arena. It certainly seems the more ambitious the plan, the less likely it will receive serious consideration. Remember the tax proposals in the Simpson-Bowles Plan?[2] That's OK, neither do we.

Rep. Dave Camp (R-MI), Chairman of the House Ways & Means Committee, has combined, and improved upon, his various 2013 Discussion Drafts for tax reform into a proposed revamp of the entire Internal Revenue Code, which is entitled, the "Tax Reform Act of 2014." Will this go in the dustbin of history or be the blueprint for future tax legislation? While initial signs are not entirely positive,[3] on occasion, ambitious proposals have served as the basis for later game-changing rules. For example, some readers may remember 1976's Limitation on Artificial Loss ("LAL") proposal. Even if you do not, you now know these rules as the passive activity loss ("PAL") rules, which were enacted in 1986.

The Ways & Means Committee released a summary explanation (the "Bill Summary"),[4] and the Joint Committee of Taxation released a detailed explanation (the "JCT Report"),[5] of the proposed legislation, which we'll call the "Bill." The financial instrument proposals described below build on the Ways & Means Discussion Draft for tax reform of financial products released on January 23, 2013 (the "Discussion Draft").[6] Given the similarities of many of the provisions in the Bill to those in the Discussion Draft, the Technical Explanation of the Discussion Draft provides relevant insight to the Bill. We'll start with definitions and then move into the proposed rules.

The Definition of a Derivative

The Bill would add a definition of a "derivative" to the Internal Revenue Code.[7] This approach, in and of itself, is novel. Currently, the Code does not contain a blanket definition of a derivative. Under Proposed Code § 486, a derivative would include "any contract (including any option, forward contract, futures contract, short position, swap, or similar contract)" if it references any of eight specified types of property. Those specified types of properties are (i) any share of stock in a corporation (Depositary Receipts, such as ADRs, are treated as stock of the underlying corporation[8]), (ii) any partnership or interest in a partnership or trust, (iii) any evidence of indebtedness, (iv) certain interests in real property,[9] (v) any actively-traded commodity, (vi) any currency, (vii) any rate, price, amount index, formula or algorithm and (viii) any other item specified by the Internal Revenue Service (the "IRS"). It appears

that the admonition in the Discussion Draft that "the definition of a derivative is intended to be broad" continues to apply.

Proposed Code § 486(c) would provide that each derivative within a host instrument is separated out from the host instrument, unless one or more components cannot be separately valued. In that case, the instrument is treated as a single derivative. Special rules are provided for debt instruments with embedded derivatives such as convertible debt (which can be thought of as a straight debt instrument coupled with a purchased call option). Under this special rule, a debt instrument is not treated as a derivative "merely because" it is denominated or payable in a nonfunctional currency, it is convertible or the parties are required to use an alternative payment schedule for interest income and expense on the debt instrument under the original issue discount ("OID") rules.[10]

There is a significant list of exceptions for contracts that fall within the definition, but that the Bill would exempt from the treatment of derivatives (described below). The following contracts are not treated as derivatives:

- Regular and foreign currency hedging transactions.[11]
- Securities lending transactions ("Section 1058 securities loans") and sale-repurchase transactions.[12] The JCT Report clarifies that the exclusion applies to financing transactions.
- Employee stock options.[13]
- Insurance contracts and annuities.[14]
- Stock of members of affiliates (domestic and foreign).[15]
- Commodity derivatives, provided that the contract requires physical delivery (and permits cash settlement only in unusual and exceptional circumstances) and the commodity is used in the normal course of the taxpayer's trade or business or is for personal consumption by an individual.[16]

Mark-to-Market Treatment for Derivatives

If a taxpayer holds a derivative, it will be subject to mark-to-market treatment at year-end.[17] This provision would apply to positions established after 2014. If a position is established prior to 2015, mark-to-market treatment would apply beginning in 2020.[18] All mark-to-market gain or loss would be ordinary in character and, therefore, not be eligible for the beneficial lower tax rates applicable to long-term capital gains.[19] Importantly for individuals, mark-to-market losses will be treated as net operating losses.[20] As a result, net losses would not be subject to the 2% limitation on miscellaneous itemized deductions[21] or the 3% cap on overall itemized deductions[22] or the $3,000 per year limit on net capital losses.[23]

A mark-to-market adjustment is required immediately prior to a disposition of a derivative.[24] This rule prevents non-dealer holders of derivatives from recognizing capital gains on derivatives by disposing of such positions prior to a year-end.

Mark-to-market treatment applies to derivatives for which there is no public market, even if the reference property itself is not publicly traded. Taxpayers would not be permitted to take any blockage discount into account in determining the fair market value of a position.[25] The JCT Report states that non-tax financial statements showing mark-to-market values should be used in determining fair market value. Nonetheless, the daunting task of determining fair market value of non-traded positions is likely to be a significant impediment to any implementation of this rule.

Furthermore, even though certain real property interests are carved-out of the definition of reference property for derivatives, derivatives include any interest in a partnership or trust. It is an open question as to whether a derivative over a partnership interest in a partnership that holds an operating business or excluded real

property is treated as a derivative. For example, if a parent grants a call option on stock or a partnership interest in a closely held operating business to a child, would that option be treated as a derivative? As discussed immediately below, such a transaction could have significant tax consequences as a result of the fact that the option could be treated as a derivative.

Straddles

A straddle exists when a taxpayer enters into offsetting positions with respect to personal property, such as stock, debt or a commodity.[26] Under the Bill, if a taxpayer enters into a straddle and one of the positions in the straddle is a derivative, both of the legs of the straddle would be subject to mark-to-market and ordinary treatment.[27] Under a wildly lopsided rule in favor of the government, if there is built-in gain on a non-derivative position that becomes subject to a straddle, that gain is immediately recognized.[28] The gain recognition rule would not apply if the non-derivative position is straight (non-convertible) debt or if the straddle consists of stock and a qualified covered call option.[29] On the other hand, if there is a built-in loss on a non-derivative position that becomes subject to a straddle, such loss is separately accounted for and taken into account only when that position is sold or otherwise disposed of.[30] If a taxpayer terminates one leg of a straddle, all of the positions comprising such straddle are marked to market at that time.[31] If the derivative is terminated, any built-in loss existing at the inception of the straddle remains unrecognized.

If we return to our example of the parent granting an option over a closely held business interest to a child, such a transaction could have the effect of (i) causing immediate gain recognition with respect to the position and (ii) converting all future appreciation in the position into ordinary income. It is worth noting that the gain recognized upon entry into the straddle would retain its character as capital gain.[32]

Hedges

For federal income tax purposes, a hedging transaction must manage risk on a transaction that cannot give rise to capital gains or losses.[33] Under existing rules, a taxpayer who fails to designate a transaction as a hedge by the close of the day on which it is entered into could be required to treat all gains and losses on the hedge as capital.[34] As a result, the taxpayer could lose the ability to match losses on the hedge against gains from the hedged position. The Bill would end this trap for the unwary by treating certain financial accounting, and other, hedge designations as hedge designations for federal income tax purposes.[35]

In order to take advantage of this deemed tax hedge identification, the transaction will need to have been treated as a hedge for tax purposes.[36] In other words, a taxpayer will not be able to report a transaction as giving rise to capital gain or loss (or presumably as subject to the new mark-to-market rules) and then later say that it is entitled to hedge treatment.

Insurance companies actively hedge their bond portfolios, but only intermittently dispose of the bonds themselves. The bond portfolios generally constitute capital assets in the hands of the insurance companies. As a result, the risk mitigation transactions engaged in by insurance companies with respect to their bond portfolios do not constitute hedging transactions for federal income tax purposes. This mismatch caused insurance companies to recognize unusable capital losses from hedge terminations while locking in a deferred gain on the hedged bond. The Bill would alleviate this challenge beginning in 2015 by allowing insurance companies to treat debt instruments as ordinary property assets for hedge purposes only.[37] As a result, gains and losses on bond hedging transactions would be treated as ordinary, even though the bond would remain a capital asset in the hands of the insurance company.

In general, subpart F income is earned by a controlled foreign corporation (a "CFC") that is currently taxable to a US shareholder of the CFC.[38] Beginning in 2015, the Bill broadens an exemption from the subpart F income. The Bill would allow CFCs to treat transactions that manage risk on "section 1231 property" as eligible for the commodity hedging exception.[39] Section 1231 property includes property subject to the allowance for depreciation that is not includible in inventory.[40] It is a fairly broad category of property.

Changes to the Rules Governing Debt Instruments

CONVERTIBLE DEBT INSTRUMENTS

Under current law, a holder of a convertible debt instrument is taxable only on the interest paid or accrued on the instrument. Under the Bill, a holder of a convertible debt instrument would be required to accrue income in respect of the conversion feature.[41] When a bond is acquired at issuance, this should represent the amount by which the interest cost of the conversion feature lowers the overall borrowing cost. For example, if an issuer would have had to pay interest at 5% on a non-convertible debt, but was able to issue a convertible bond with comparable terms for 2%, then issuer would deduct and the holder would accrue 3% per annum. It is unclear whether this forced accrual would constitute portfolio interest in the hands of a non-US holder of the debt. It is also uncertain as to whether the income would be adjusted by bond premium in the hands of a secondary holder. This forced accrual would also have the effect of converting capital gains into ordinary income for taxable US holders. Given the sophistication of the convertible bond market, this proposal would likely have a depressing effect on convertible bond offerings if it became law.

CURRENT INCLUSION OF MARKET DISCOUNT

The Bill would require current inclusion of market discount in income for debt instruments acquired in 2015 and thereafter.[42] Holders of market discount bonds would accrue the discount on an economic yield-to-maturity (OID) basis, not straight-line.[43] The maximum amount of market discount that a holder would be required to include in income would be equal the excess of the product of (i) the greater of the (a) applicable federal rate plus 10% and (b) the original yield to maturity on the bond plus 5% and (ii) the adjusted basis of the bond *over* the qualified stated interest and OID paid or accrued during the period.[44] Market discount would be treated as interest for all purposes, including being treated as tax-exempt interest.[45] Losses sustained on the disposition of a market discount bond would be treated as ordinary losses to the extent of prior market discount income.[46]

This proposed rule would have a dramatic effect on the federal income tax considerations for US investors applicable to investments in the distressed debt markets. As the Bill Summary states, the market discount rules have the unanticipated effect of treating discount attributable to the deterioration of a borrower's creditworthiness in the same manner as discount attributable to changes in market interest rates.[47] As a result, certain distressed market investors apply alternate accounting to extreme discount attributable to a loss of borrower creditworthiness. The proposed rules would require phantom income accrual to the holding of purely speculative distressed debt positions. This could cause US taxable investors to shy away from investing in distressed mortgage portfolios.

Because the market discount would not generate current income for non-US investors, the provision has the perverse effect of encouraging foreign money into the distressed mortgage and consumer receivable markets and keeping domestic money at bay. It is possible that the tax policy implications of this rule should be revisited, especially in light of the low revenue estimates for this provision. Market discount

would be reportable by brokers for bonds acquired by customers in 2015 and thereafter.[48]

DEBT EXCHANGES TO BE NONTAXABLE

In contrast to the negative effects that the proposed changes to the market discount rules could have on distressed debt investing, the Bill would lessen the adverse federal income tax consequences from debt modifications in order to encourage distressed debt work-outs, a "process necessary to economic recovery."[49] First, the Bill would limit the amount realized when a holder of a distressed debt exchanges the old debt for a new debt instrument (either actually or through a significant modification). The Bill would limit the amount realized in that exchange to the least of (i) the adjusted issue price of the old debt, (ii) the stated principal amount of the new debt and (iii) the imputed principal amount of the new debt.[50] The amount realized serves as the adjusted issue price of the new debt.

The Bill would restore an old rule by creating a new Code section that treated debt-for-debt exchanges as nontaxable transactions.[51] Boot (cash) received in such transactions would be taxable only to the extent of gain. The Technical Explanation contains an example in which a person buys an outstanding $1,000 debt for $400.[52] The issuer transfers a $500 note and $100 in cash to the new debt holder in exchange for the old debt. On these facts, the example concludes that the debt holder has no gain or loss and (implicitly) concludes that the holder's basis in the new $500 note is $300. Presumably, the $200 discount would be subject to the proposed market discount rule discussed above.

CREDIT CARD INCOME

In *Capital One Financial Corp. v. Comm'r*,[53] the Tax Court held that interchange, that is, income earned by credit card issuers from merchants, should be treated as OID. This accounting has been extended to grace period interest, as well.[54] This treatment is very beneficial to credit card companies as it allows them to recognize interchange over the life of a credit card account instead of when applied. While the income has been deferred for federal income tax purposes, credit card issuers have reported these amounts as current income for financial statement purposes. The Bill would amend the timing for the inclusion of such income to be not later than the time that it is included in financial statement income.[55] Thus, the rule would end the current beneficial tax deferral.

TAX-EXEMPT BONDS

Code § 265(a)(2) provides that interest expense incurred to acquire or carry tax-exempt obligations is not allowed as a deduction for federal income tax purposes. This rule generally has been interpreted as a tracing rule, that is, interest expense will be disallowed if the indebtedness giving rise to the interest expense can be traced to the acquisition or holding of tax-exempt obligations. Since the decision in *Comm'r v. Leslie*,[56] however, it has been accepted that dealers in tax-exempt obligations are subject to Code § 265(a)(2) for all of their interest expense, based upon a fraction, the numerator of which is the adjusted basis of tax-exempt obligations held by the dealer and the dominator of which is the adjusted basis of the dealer's total assets.[57] The Bill would extend the *Leslie* rule to all C corporations.[58] In addition, for non-corporate taxpayers, investment interest would be deductible only to the extent that it exceeds tax-exempt interest.[59]

Expansion of the Wash Sale Rules

The wash sale rules deny current tax losses on securities sales if the taxpayer re-establishes his position (directly or through certain derivatives) within a 61-day period beginning 30 days prior to the disposition transaction.[60] The Bill would expand the wash sale loss disallowance rule by looking to see if a position was re-established by a related party during the 61-day period. Related party would mean: the taxpayer's spouse; any dependent of the taxpayer; any individual, corporation, partnership, trust, or estate that

controls, or is controlled by the taxpayer or any individual described by the taxpayer; any individual retirement plan, Archer MSA, or health savings account; and any retirement account if the taxpayer has the right to make any decision with respect to the investment of any amount in such account.

Taxation of the Time Value of Money Element in Certain Stock Forward Contracts

A corporation has never recognized gain or loss on transactions involving its own stock.[61] This rule has been extended to option transactions by corporation involving its own stock.[62] A corporation could use forward transactions involving its own stock to disguise the receipt of interest income. For example, assume that the fair market value of a share of stock is $1,000 and a shareholder of the corporation has a cost of funds of 5%. The corporation could acquire a share of stock from an unrelated shareholder for $1,000. The corporation could then enter into a forward contract with the shareholder to deliver a share of stock in one year for a price of $1,050. The $50 excess over the fair market value of the stock represents compensation to the corporation for financing the buyer's purchase. The Bill would treat this excess as taxable interest income in any case in which there was a related redemption of stock by the corporation.[63]

The (Long-Suffering) Carried Interest Proposal

The Obama Administration has proposed recharacterizing capital gains earned through and with respect to dispositions of investment partnership service interests ("IPSIs") as ordinary income since the President's first term. These proposals have been referred to as the carried interest proposals. The Bill would enact a carried interest proposal that is significantly different than the various versions that President Obama has proposed for last several years. A full analysis of this proposal is beyond the scope of this article. Certain key features of the Bill's carried interest proposal are as follows:

- The carried interest proposal would apply to dispositions of interests in affected partnerships as well as recharacterizing income earned through such partnerships.
- The Bill's carried interest proposal creates a "recharacterization account balance," which limits the amount that would be recharacterized as ordinary income.
- The recharacterization account balance is keyed to the long-term applicable federal long-term rate plus 10% per annum and the maximum percentage of profits that could be allocated to the holder of the affected partnership interest.
- The Bill would override the normal partnership distribution rules by treating distributions of property, made in exchange for affected partnership interests, as taxable dispositions of the partnership interests, instead of distributions.
- In contrast to the Obama Administration proposals, the Bill would apply only to partnerships engaged in raising capital, investing in businesses and developing trades or businesses. Partnerships engaged in real estate businesses would be exempt from the proposal.

The Bank Tax

The Bill proposes to impose a .35% (35 bps) excise tax on the assets of banks and insurance companies, in excess of $500 billion, that are considered "systematically important financial institutions," beginning in 2015.[64] These financial institutions are those subject to Section 165 of the Dodd-Frank Wall Street Reform Act.[65] The $500 billion would be indexed for inflation. This provision would be expected to raise over $86 billion over 9 years.[66]

Concluding Thoughts

While the prospect for passage of the Tax Reform Act of 2014 is unclear, these proposals are important to understand because they are likely to frame the debate for tax legislation in the future. The carried interest proposal in particular has been debated for a number of years. The scaled back version emerging from the Republican side of aisle shows that it may now have bipartisan support. Like the LAL proposal, these proposals may emerge in various incarnations in future tax bills.

Endnotes

1 Mark Leeds is a tax partner with the New York office of Mayer Brown and the editor-in-chief of Derivatives: Financial Products Report. Mark is serving as the chairman of the Tax Executives Institute conference on Financial Products in Chicago on April 23, 2014 and will be addressing the proposals discussed in text at that conference.

2 http://en.wikipedia.org/wiki/National_Commission_on_Fiscal_Responsibility_and_Reform

3 See McKinnon, *Camp Plan Has Something for Everyone (to Hate)*, Wall Street Journal Washington Wire (February 26, 2014).

4 Committee on Ways & Means, Section-by-Section Summary of the Tax Reform Act of 2014 (Discussion Draft) (February 26, 2014).

5 Joint Committee on Taxation, TECHNICAL EXPLANATION OF THE TAX REFORM ACT OF 2014, A DISCUSSION DRAFT OF THE CHAIRMAN OF THE HOUSE COMMITTEE ON WAYS AND MEANS TO REFORM THE INTERNAL REVENUE CODE: TITLE III — BUSINESS TAX REFORM (JCX-14-14) (February 26, 2014).

6 *See* TECHNICAL EXPLANATION OF THE WAYS AND MEANS COMMITTEE DISCUSSION DRAFT PROVISIONS TO REFORM THE TAXATION OF FINANCIAL INSTRUMENTS (January 24, 2013).

7 The definition of a derivative in the Bill is an improvement over the definition of a derivative contained in the Discussion Draft which defined a derivative as, *inter alia*, a derivative instrument.

8 Proposed Code § 486(d).

9 Real estate held as inventory and tracts of land are carved out of the definition of real property for this purpose. Proposed Code § 486(b).

10 Proposed Code § 486(c)(2).

11 Proposed Code § 486(b)(2).

12 Proposed Code § 486(b)(3).

13 Proposed Code § 486(b)(4).

14 Proposed Code § 486(b)(5).

15 Proposed Code § 486(b)(6). Affiliates generally would be corporations connected by an 80% stock and value test. See Code § 864(f)(1)(C),

16 Proposed Code § 485(b)(7).

17 Proposed Code § 485(a)(1).

18 Bill § 3401(g).

19 Proposed Code § 485(b)(1).

20 Proposed Code § 485(b)(2).

21 Code § 67(a).

22 Code § 68(a).

23 Code § 1211(b).

24 Proposed Code § 485(d)(1); *see also* Code § 475(a)(1); Prop. Treas. Reg. 1.475(a)-2(a) (mark-to-market adjustment required by a dealer in securities immediately prior to any disposition of the security).

25 Proposed Code § 485(e)(2).

26 Code § 1092(c)(1).

27 Proposed Code § 485(c)(1).

28 Proposed Code § 485(c)(2).

29 Proposed Code § 485(c)(2)(C), (D).

30 Proposed Code § 485(c)(3).

31 Proposed Code § 485(d)(2).

32 JCT Report at 153.

33 Code § 1221(b)(2).

34 Treas. Reg. § 1.1221-2(g)(2)(i).

35 Prop. Code § 1221(b)(3).

36 Prop. Code § 1221(b)(4) (flush lang.)

37 Prop. Code § 1221(b)(4).

38 Code § 951(a).

39 Prop. Code § 954(c)(5)(A).

40 Code § 1231(b).

41 Bill § 3401(d).

42 Prop. Code § 1278(a).

43 Prop. Code § 1278(b).

44 Prop. Code § 1278(c).

45 Prop. Code § 1278(d)(1).

46 Prop. Code § 1278(d)(3).

47 Bill Summary, p. 98.

48 Prop. Code § 6045(f).

[49] Bill Summary, p. 99.

[50] Prop. Code § 1274B(a).

[51] Prop. Code § 1037, restoring the prior rule from pre-1984 Code § 1031(a).

[52] JCT Report, p. 166.

[53] 133 T.C. No. 8 (2010).

[54] See Rev. Proc. 2013-26, 2013-22 I.R.B. 1160.

[55] Prop. Code § 451(b).

[56] 413 F.2d 636 (1970), cert. den. 396 U.S. 1007 (1970)

[57] *See* Rev. Proc. 72-18, 1972-1 C.B. 740, § 7.02.

[58] Prop. Code § 265(b).

[59] Prop. Code § 265(b)(1).

[60] Code § 1091(a).

[61] Code § 1032(a).

[62] *Id.*

[63] Prop. Code § 1032(b).

[64] Prop. Code § 4491(a).

[65] Generally, an institution is subject to the section 165 of Dodd-Frank if it is a nonbank financial company supervised by the Board of Governors of the Federal Reserve or a bank holding company with total consolidated assets equal to or greater than $50 billion. JPMorgan Chase & Co. (JPM), Bank of America Corp., Citigroup Inc. (C), Wells Fargo & Co. (WFC), Goldman Sachs Group Inc. (GS) and Morgan Stanley (MS) would be affected. See Rubin, Biggest Banks Said to Face Asset Tax in Republican Plan, Bloomberg (February 25, 2014) http://www.bloomberg.com/news/2014-02-25/biggest-banks-said-to-face-asset-tax-in-republican-plan.html.

[66] Bill Summary, p. 151.

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