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LEGAL ALERT

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Camping on "The Street": A First Step in the Reform of the Taxation of Financial Instruments and Products

On January 24, House Ways and Means Committee Chairman Camp (R-MI) released a discussion draft of proposals to reform the taxation of certain financial instruments and products (the Camp Draft). In brief, the Camp Draft:

- Requires most derivatives to be marked-to-market on an annual basis, subject to some limited exceptions;
- Modifies the rules for determining issue price in debt modifications and exchange transactions;
- Mandates the current inclusion of market discount in income over the life of a bond;
- Liberalizes hedge identification requirements;
- Directs the use of the average basis method for purposes of calculating gain or loss on the sale, exchange, or other disposition of specified securities; and
- Offers several proposals that mainly are of interest to individual taxpayers, including an expansion of the scope of the wash sale rules.

While the Camp Draft is only a proposal, it does offer a glimpse into possible changes that may be in the offing, and the preliminary response from Treasury officials has been positive.

Mark-to-Market on Almost All Derivatives

As noted above, the Camp Draft requires most derivatives to be marked-to-market on an annual basis, subject to some limited exceptions. The Camp Draft also eliminates capital gain or loss treatment for these derivatives.

Currently, the taxation of a derivative varies widely based on the status of the holder and the structure of the derivative. Gain may be capital or ordinary depending on the derivative, and gain or loss may be recognized through mark-to-market (*e.g.*, section 1256 contracts), upon a realization event (*e.g.*, options), or after a realization event in certain cases (*e.g.*, a straddle).

The Camp Draft seeks to reduce this divergence of federal income tax consequences by requiring derivatives to be reported on an annual basis under a mark-to-market regime, with some limited exceptions. Under this approach, each derivative would be treated as if it was sold on the last day of the year, and any gain or loss would be recognized in that year. If the holder retains the derivative beyond that year, adjustments would be made to take into account taxes imposed in prior years under the mark-to-market approach.

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Sutherland Observation: Legislation was enacted as part of Dodd-Frank to except notional principal contracts and swaps, which now generally are required to be traded through a central clearinghouse, from mark-to-market treatment under section 1256. This proposal effectively would reverse that rule.

In addition, *all* income, gain, loss, and deduction arising from a derivative that is subject to this proposal would be treated as ordinary, eliminating the disparate treatment among types of derivatives or their holding periods. Furthermore, the mark-to-market and ordinary treatment rules of the proposal would apply to all positions in a straddle that include any derivative to which the proposal applies, even if those positions are not otherwise marked-to-market (*i.e.*, a mixed straddle).

The Camp Draft attempts to exempt what the Chairman refers to as "common transactions involving derivatives," such as hedges used to mitigate price or risk, currency, and interest rate fluctuations, and hedges on real estate transactions.

Retaining Issue Price in Debt Restructurings

The Camp Draft also changes the rules for determining issue price when there is an exchange of an old debt instrument for a new debt instrument or there is a significant modification of a debt instrument resulting in a deemed exchange.

Under current law, in a debt-for-debt exchange (or a significant modification of a debt instrument), the issuer is treated as settling the old debt instrument for an amount equal to the issue price of the new debt instrument. If the issue price of the new debt instrument is less than the adjusted issue price of the old debt instrument, the issuer may recognize COD income. However, if the issue price of the new debt instrument is greater than the adjusted issue price of the old debt instrument, the issuer may be entitled to a current deduction for the amount of the retirement premium (the determination of whether this deduction is allowed depends on whether either the old debt instrument or the new debt instrument is publicly traded).

The Camp Draft seeks to eliminate COD income in these circumstances, which it calls "phantom income," by requiring that the issue price of the new debt instrument be the *lesser of* (i) the adjusted issue price of the old debt instrument *or* (ii) the issue price of the new debt instrument that would be determined under section 1274 if the new debt instrument were a debt instrument to which that section applied (*i.e.*, the principal amount if there is adequate stated interest or, otherwise, the imputed principal amount). Thus, if the principal amount of the new debt instrument does not depart from the principal amount of the old debt instrument, the issuer would not recognize COD income under this proposal.

Sutherland Observation: While the articulated focus of the provision is the elimination of "phantom" COD income, the implication for the deduction of retirement premium under current law is unclear. Any future legislation should clarify that there is no intended change to existing rules relating to the deduction of retirement premium when the issue price of the new debt instrument exceeds the issue price of the old debt instrument.

Current Inclusion of Market Discount

The Camp Draft also calls for the current inclusion of market discount in income over the life of a bond. By way of background, where a purchaser buys a bond after original issue for less than its original issue price, creating a "market discount," none of that discount is recognized under current law until disposition of the bond (absent an election to do so). When the bond is disposed of, any amount of market discount

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that is realized is treated as ordinary income. For example, assume that a taxpayer purchases a bond that has a face value and an issue price of $1,000, and an annual $50 coupon, for $950 after original issue. In this example, the bond has a $50 market discount, which is not recognized until disposition of the bond. When the bond matures and pays $1,000, the purchaser would recognize $50 of ordinary income.

The Camp Draft would change the recognition of market discount income by treating market discount in the same way that original issue discount is treated, requiring a daily accrual. The Camp Draft also would treat market discount income as interest income. Thus, in the above example, the purchaser would recognize the $50 market discount as interest income over the period that the purchaser holds the bond, up to maturity. At maturity, there would be no additional market discount gain recognized.

Sutherland Observation: Although the proposal to tax market discount currently may better reflect the income of the holder, the current accrual of market discount would increase complexity for taxpayers and may be difficult for the IRS to administer because of the variety of prices at which bonds may be purchased in the open market. Accordingly, consideration should be given to limiting the current accrual requirement to non-publicly traded obligations.

Notably, the proposal would place a cap on how much market discount must be included in income, with the cap being the *greater of* (i) the bond's original yield to maturity plus 5% *or* (ii) the applicable federal rate of the bond plus 10%.

Relaxed Hedge Identification Requirements

The Camp Draft also eases the requirements for identifying hedging transactions by recognizing a hedge as being identified for federal income tax purposes if it either is identified in accordance with the Treasury regulations *or* is identified in audited financial statements. Under current Treasury regulations, a hedge must be identified as a hedge for federal income tax purposes specifically, regardless of whether it also is identified as a hedge for accounting or other regulatory purposes. Failure to identify the hedge for federal income tax purposes on the day into which it is entered serves to eliminate preferential tax treatment for the hedge.

Cost Basis of Specified Securities

The Camp Draft also eliminates the use of the "specific identification" and "first-in-first-out" methods when determining the basis of any specified security sold, exchanged, or otherwise disposed of. Instead, the basis of the sold securities would be determined using the average basis method now permitted for regulated investment company stock. Correspondingly, the proposal also requires that brokers use the average basis method in satisfying their basis reporting requirements.

To facilitate the determination of the cost of a specified security in accordance with the average basis method, the proposal would treat any specified security that is acquired before January 1, 2014, as in a separate account from any security that is acquired on or after that date. Accordingly, a taxpayer would determine the basis of any specified security acquired in 2014 and later by disregarding the basis of specified securities acquired before 2014.

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Other Proposals

The Camp Draft offers several other proposals, which are summarized below.

- One proposal allows individuals to claim above-the-line deductions for amortizable bond premium.
- A second proposal alters how accruals are treated on certain short-term government obligations (*e.g.*, U.S. savings bonds).
- A third proposal expands the wash sale rules to apply not just to a specific individual, but also to parties related to that individual (such as the individual's retirement arrangement (*e.g.*, an IRA)), and eliminates the basis adjustments for disallowed losses on most such "related party" wash sales.

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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