December 2, 2011

The Honorable Max S. Baucus
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Dave Camp
Chairman
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Orrin G. Hatch
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Sander Levin
Ranking Member
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

Re: Options for Tax Reform Relating to Financial Transactions

Dear Chairmen and Ranking Members:

Enclosed please find a description of options for tax reform relating to financial transactions. These options for tax reform are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These options are submitted as part of a series of tax reform options prepared by the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and administer.

The Section would be pleased to discuss the options with you or your staffs if that would be helpful.

Sincerely yours,

Charles H. Egerton
Last Retiring Chair, Section of Taxation

Enclosure

cc: Mr. Russell Sullivan, Majority Staff Director, Senate Finance Committee
Mr. Christopher Campbell, Minority Staff Director, Senate Finance Committee
Mr. Jon Traub, Majority Staff Director, House Ways and Means Committee
Ms. Janice A. Mays, Minority Chief Counsel, House Ways and Means Committee
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
Honorable Emily S. McMahon, Acting Assistant Secretary (Tax Policy), Department of the Treasury
Honorable William J. Wilkins, Chief Counsel, Internal Revenue Service
Honorable Douglas H. Shulman, Commissioner, Internal Revenue Service
These options for tax reform ("Options") are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These Options are submitted as part of a series of tax reform options from the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and to administer.

These Options were prepared by individual members of the Financial Transactions Committee of the American Bar Association Section of Taxation. Principal responsibility for preparing these Options was exercised by Jason Chlipala, Dale Collinson, David Garlock, Jeffrey Maddrey, Eileen Marshall, Erika Nijenhuis, and Matthew Stevens of the Financial Transactions Committee (the "Committee"). These Options were coordinated and reviewed by Lucy Farr, Chair of the Committee. They were further reviewed by Steve Rosenthal, Council Director for the Committee, and by Peter Blessing, on behalf of the Committee on Government Submissions.

Although many of the members of the Section of Taxation who participated in preparing these Options have clients who may be affected by the federal tax principles addressed in these Options or who have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Options.

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Date: December 2, 2011
# Options for Tax Reform
## Financial Transactions

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I. Executive Summary

Our goal for this report was to identify areas of the tax law related to financial transactions that we believe should be reformed. We did not attempt a complete overhaul of the tax rules applicable to financial transactions; rather, we attempted to address discrete issues that we believe arise regularly under the current statutory framework. Although in places we identified areas where regulations could be helpful or necessary, we strove to discuss problems that can, and should, be addressed legislatively.

The report is broken up into four sections. The first section deals with debt instruments. It contains several interrelated options that would modify the treatment of debt of distressed companies, with a view to aligning debt investors’ taxable income with actual economic returns from the debt. In particular, we identify options that would limit the rate at which interest and market discount accrue on all debt instruments, and eliminate their current accrual altogether in the case of severely distressed debt. To prevent character mismatches, we identify as an option that losses on debt instruments be treated as ordinary to the extent of prior ordinary income inclusions. We also identify as options certain changes to the rules governing debt-for-debt exchanges, with a purpose of avoiding the recognition by a debt issuer of cancellation-of-debt income in connection with a restructuring where the principal amount of the debt does not change. Finally, we identify as an option repealing Section 279 of the Code because most of Congress’ original concerns at enactment of the provision no longer apply, and are better addressed by other Code provisions in any event.

The second section of the report relates to the character of gain and loss on derivatives. We identify options for simplifying and unifying the rules in Sections 1234, 1234A and 1234B that relate to dispositions of derivatives, which under current law can apply differently depending on the type of disposition and the type of derivative. The option attempts to provide a consistent set of rules, while retaining the link between dispositions of a derivative and dispositions of the underlying property, a key feature of current law. Very generally, the option would provide that the character of any gain or loss on the disposition of a derivative match the character of a sale of the underlying property (and if the derivative is not with respect to property, that the character match the character of any gain on the sale of the derivative). We also identify as an option repealing Section 1236 and significant portions of Section 1233 given that they are largely redundant under current law. Finally, we identify as an option eliminating the requirements under Section 1221 and 1256 to identify hedging transactions in certain instances that we believe are both likely to be valid hedges and unlikely to present opportunities for abuse.

The third section of the report relates to mark-to-market treatment for financial transactions. We identify options for updating Section 1256 based on the dramatic changes to the financial transactions markets, and to the types of financial instruments, that have taken place since that section was enacted in 1981. In particular, we identify the option of unifying the treatment of dealers in Section 1256 contracts with the treatment of dealers in securities, and of modifying Section 1256 to include certain newer financial instruments whose economics make them appropriate for mark-to-market treatment. Furthermore, we identify as an option that all taxpayers be able to make the Section 475(f) election to mark all their securities to market, as long as the election is made in advance and with respect to all securities (with a view to eliminating any danger of cherry-picking).

The final section contains three options that do not fit into any of the previous sections. We identify options for modernizing the Section 1091 wash sale rules and Section 1032 to better deal with the numerous new financial products that have been developed since those provisions were enacted and that are not presently addressed in a clear fashion. Finally, we identify the option of treating swap expenses as above-the-line deductions because we do not believe the limitations on miscellaneous itemized deductions were intended to, or should, apply to losses on derivatives.
II. Options for Tax Reform: Financial Transactions.

A. Debt Instruments

1. Revise the treatment of market discount and OID on distressed debt

Present law

The rules governing the taxation of debt instruments are a mix of statutory rules, regulations and common law. Separate but interrelated rules apply to qualified stated interest, original issue discount ("OID") and market discount.

Qualified stated interest is defined in regulations as interest payable unconditionally at least annually in cash at a single fixed or floating rate. Holders of debt instruments account for qualified stated interest under their regular method of accounting for tax purposes, generally the cash or accrual method.

Holders must account for OID on a debt instrument as it accrues, based on a constant yield to maturity, regardless of their regular method of tax accounting. OID is defined in regulations as the excess of (i) the sum of all payments on the debt instrument other than qualified stated interest over (ii) the issue price of the debt instrument. Under this definition, interest that is payable in kind ("PIK interest") is treated as OID for tax purposes.

Market discount is generally defined as the excess of a debt instrument’s revised issue price over the holder’s basis in the debt immediately after acquisition. The revised issue price of a debt instrument is its issue price plus the aggregate accruals of OID, if any, prior to the acquisition date and minus all prior payments other than payments of qualified stated interest. Unless a taxpayer so elects, market discount need not be included in income as it accrues, even by an accrual method taxpayer. Rather, (i) any gain on the sale or other disposition of a market discount bond, and (ii) any payment on the bond (other than a payment of qualified stated interest) is treated as ordinary income to the extent of the accrued market discount at the time of the disposition or payment. Market discount accrues (i) on a constant yield basis (using OID principles) if the taxpayer so elects or, if not, (ii) for a bond calling for only qualified stated interest payments prior to the maturity date, on a straight line basis, or (iii) in any other case, in a manner to be prescribed by regulations. No such regulations have ever been issued.

A retirement of a debt instrument is deemed to be an exchange transaction, so that gain or loss on the retirement of a debt instrument held as a capital asset is treated as capital gain or loss. Originally applicable only to corporate and government obligations, this rule was extended to all debt instruments in 1997.

Regulations provide that any payment on a debt instrument is treated first as a payment of interest to the extent accrued at the time of the payment and as a payment of principal to any remaining extent. No exception to this rule is made for the final settlement of a debt instrument at a discount.

With very limited exceptions, the statutes and regulations governing debt instruments have no exceptions or special rules for distressed debt instruments. A distressed debt instrument might be defined as any debt instrument for which there is a substantial risk that the obligor will not be able to make all of the required payments on the debt as they come due. Common law, however, contains several principles applicable to distressed debt. The first is that a holder of a
debt instrument using the accrual method of accounting need not include interest in taxable income as it accrues if, at the time of the accrual, there is no reasonable expectation that the interest will be paid (the “doubtful collectability” rule). The Internal Revenue Service (the “Service”) has taken the position that this common law rule does not apply to OID.

The second common law rule is that if a debt investment is “speculative,” any payments on the debt instrument other than stated interest payments can be applied to reduce the holder’s basis in the debt without the recognition of gain unless and until the holder’s basis has been reduced to zero. The cases that form the basis of this common law rule antedate the enactment of the market discount rules, and it is not clear to what extent the common law rule survives.

Reasons for change

The general absence of exceptions or modifications to the rules governing the taxation of debt for distress situations can produce inappropriate timing results for holders in many cases, and in some of these cases inappropriate character mismatches also arise (ordinary income followed by a capital loss). Among the most common situations in which these results can arise are: (i) a holder is required to include OID in income when there is no reasonable expectation of collection, (ii) the ordering rule treats as interest payments that reflect the economic return of the holder’s basis (i.e., because it is clear that a debt instrument will not be paid in full) and (iii) the market discount rules are applied without modification for distressed debt.

For example, consider a case where the taxpayer holds a distressed bond bearing PIK interest. Although there may be a high likelihood that the issuer will fail to pay the PIK interest and principal in full at maturity, the Service takes the position that the holder is required to keep accruing the PIK interest into income as OID, with the likely result that the holder will earn significant ordinary income followed by a capital loss. Alternatively, a holder may acquire a severely distressed debt instrument that is nonetheless paying stated interest currently even though there is little to no chance that much if any principal will be repaid. This situation can arise in the context of asset-backed securities, where (absent default) the payment “waterfall” pursuant to a security’s indenture typically requires the payment of stated interest prior to the payment of principal. Under the payment ordering rules contained in the regulations, the stated interest received will generally be required to be included in full by the holder as ordinary income. If a holder acquires such a security bearing an 8% coupon at the discounted price of 40% of par, for example, the interest income required to be included by the holder in full would effectively represent a rate of 20% when applied to the holder’s purchase price, a result significantly in excess of the holder’s true expected economic return.

The market discount rules were enacted at a time of high interest rates, which caused most outstanding debt instruments to trade at a discount. Congress correctly understood that, in

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2 T.A.M. 9538007 (June 13, 1995).


4 See T.A.M. 9538007, supra note 2.
such a high-interest environment, market discount is like OID, i.e., an economic equivalent of interest. In that context, it is appropriate to treat market discount like OID because both are “fixed and predictable.”\footnote{See Revenue Proposals Contained in the Administration's Fiscal 1985 Budget, General Explanations (Feb. 23, 1984) (“Market discount is in all respects the equivalent of interest income to the holder of a bond; it exists in lieu of coupon interest, and is reflected in the fixed and predictable growth in value of the bond according to a compound interest formula.”)} Congress failed to recognize, however, that market discount can arise from a source having nothing to do with high prevailing interest rates: doubt as to the borrower’s ability to pay the debt according to its terms. At a high enough level, that form of market discount is entirely distinguishable from OID: it is no longer predictable that it will be paid, and newly-issued “debt” bearing an equivalent amount of OID would, in the event an issuance of such debt even occurs as a practical matter, most likely be treated as equity rather than debt for tax purposes. In that context, taxing market discount as an OID-equivalent is not rational.

To address systematically the inappropriate timing and character consequences arising from the application of the interest, OID and market discount rules to distressed debt, we offer two main options to change the tax treatment of distressed debt instruments. These options could be enacted separately or together. The first option generally limits the rate of accrual on any debt instrument to a rate chosen to represent the upper limit of yields on newly issued debt instruments. The second is limited to severely distressed debt instruments and provides for no accrual whatsoever on instruments in this category. Both options have character rules designed to correct the character mismatches noted above.

A third option would essentially codify the principles of the doubtful collectability authorities, i.e., that yield should not be accrued if there is no reasonable expectation that the holder will collect it.\footnote{See supra note 1.} This would provide certainty to taxpayers that the concepts underlying these cases apply equally to OID as to interest. A final option would require accrual-method taxpayers to include all accruals of interest and discount (including market discount) in income on a current basis, subject to the limitations in the other proposals. A separate but related option described in section II.A.2 of this submission would also address the character mismatches arising from distressed debt by treating certain losses on debt as ordinary.

Note that these options would affect the taxation only of holders of debt instruments, not issuers, and so under these options the interest deductions for issuers of debt would not necessarily match the inclusions of interest income by holders of that debt. Nonetheless, except in the case of severely distressed debt instruments (proposal 2) and debt instruments of doubtful collectability (proposal 3), an initial holder of debt would generally have treatment symmetric to that of the issuer under the proposals.\footnote{However, note that a holder that takes a partial worthlessness deduction would in a sense be treated as a “new” holder of the relevant debt; this is appropriate because the partial worthlessness rule functions as a form of “reset” of the holder’s position.} Asymmetric treatment as to the issuer is entirely appropriate for a

\footnote{Although option 1 is not designed to have an effect on initial holders of debt, such a holder might sell and reacquire the debt or cause a deemed termination of the debt under Section 1001 in order to try to get the benefit of the proposal. However, in many such cases the wash sale rules would apply, with the result that the holder’s basis for the newly reacquired or modified debt would equal the holder’s basis in the original debt, thereby preventing the holder from benefiting from the proposal.}
secondary purchaser of debt, whose economic position ordinarily differs from both the issuer of the debt and earlier holders because that position depends significantly on the price at which the holder acquired the debt. Indeed, certain rules applicable to the taxation of a holder of debt—specifically, the acquisition premium and amortizable bond premium rules—generally recognize this principle by permitting a secondary holder’s income inclusions to deviate from the issuer’s to reflect the particular holder’s yield from holding the debt.

Options 2 and 3, which are intended to apply to debt instruments whose issuers are in considerable distress, apply to all holders including initial holders, and thus have the potential for the issuer/initial holder asymmetry mentioned above. While those options could easily be made applicable to issuers as well as to holders, given that an issuer in that condition is likely to have substantial net operating losses it seemed to us that the practical import of applying the options to issuers would be limited.

Assuming that sensible rules can be enacted to limit the accrual of interest and discount on a debt instrument to a rate that truly represents interest or an interest equivalent, there is no good reason why an accrual-method taxpayer should not be required to include accrued interest income and discount in income as it accrues, regardless of whether the return is in the form of stated interest, OID or market discount. Unlike the situation that existed in 1984 when the market discount rules were originally enacted, all taxpayers holding discount bonds should now have access to information and computing power that will allow the computation of accrued discount on a yield to maturity basis. Further, once rules have been enacted to limit the accrual of yield on a debt instrument to a rate that truly represents an economic accretion of value, the general principles of the accrual method of accounting should require current inclusion in income of the accrued interest.

Options for Consideration

Limitation on yield required to be accrued (Option 1)

Option 1 provides that, for the holder of any debt instrument:

- The rate at which the total yield on the debt accrues (i.e., interest, OID and market discount) shall not exceed the greater of (i) the applicable Federal rate (“AFR”) plus 10 percent and (ii) the debt instrument’s yield to maturity plus 5 percent.

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Another way of making this point is that when a debt instrument is sold at a loss in the secondary market, the taxation of the issuer cannot sensibly match the treatment of the original and subsequent holder of the debt. To achieve matching, the issuer would have to recognize income at the time of the sale equal to the loss recognized by the seller of the debt. But certainly this would not represent sensible tax policy, for in no sense does the issuer of debt have an item that could be called taxable income merely because its debt has been sold from one creditor to another at a loss.

The choice of the AFR plus 10 percent is based on the premise that yields on newly issued debt instruments with even the lowest credit ratings do not exceed this rate. Historically, the understanding of the Committee is that this has generally been true, except for a very brief period during the recent financial crisis. Treasury could be given the authority to provide a higher threshold should market conditions change and AFR plus 10 percent no longer represent a reasonable proxy for the highest yields on newly issued debt instruments.
percent, in each case as applied to the fair market value of the debt instrument at the time acquired by the holder.

- For this purpose, the AFR is the rate at the time of purchase for a fixed-rate debt instrument based on the term of the debt, and the Federal short-term rate at the time of the accrual in the case of a variable rate debt instrument.

- For purposes of this rule, the fair market value of a debt instrument shall be the purchase price paid by the holder if the debt was acquired for cash or publicly traded property, or the trading price of the debt instrument if the debt was publicly traded at the time of purchase and the preceding clause does not apply. In any other case, the fair market value of the debt instrument is generally deemed equal to its face amount, except that the Treasury Department shall be given authority to issue regulations permitting the taxpayer to use the true fair market value of a nonpublicly traded debt instrument in certain circumstances.

- Total yield accrued in any accrual period shall be treated first as qualified stated interest to the extent thereof, then as OID to the extent thereof, and last as market discount. Cash payments are allocated under the same ordering rule. Thus, as under current law, accrued market discount is required to be included in income only to the extent of cash payments treated as principal, unless the taxpayer elects current inclusion or the fourth proposal described below is enacted.

- If a taxpayer validly claims a deduction for partial worthlessness of a debt instrument, the rules of this option shall be applied at the time the debt is partially charged off for financial statement purposes as if the debt had been purchased on that date for a price equal to the taxpayer’s basis in the debt instrument immediately after the partial worthlessness deduction.  

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11 This prong of the option ensures that a debt instrument’s yield, as measured based on its fair market value, must rise at least 5% from its initial yield before the option would have any effect on that debt. Another consequence of this prong is that the option would not generally affect initial holders of debt, even if the debt’s yield at issuance exceeds AFR plus 10%.

12 For example, if the holder has a qualified financial statement, it could elect to follow its financial statement accounting for determining the accrual of total yield on the debt instrument. A qualified financial statement is a financial statement that is required to be filed with the SEC under Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934 and/or under Rule 17a-5 or Rule 17a-12 promulgated thereunder.

13 To be consistent with the rules applicable to market discount and short-term debt, interest on any indebtedness incurred or continued to purchase or carry a debt instrument would be deductible only to the extent income on the latter is includible in taxable income. Any excess would be carried forward to potentially offset future inclusions and, to the extent not so used, would be added to the basis of the debt for purposes of computing gain or loss on the sale or exchange (including a retirement) of the debt instrument. Additionally, in a case in which the issuer of the debt instrument is related to the holder within the meaning of Section 267(b) or (…continued)
Severely distressed debt instruments (Option 2)

This option provides that, for a holder of a severely distressed debt instrument (as defined below):

- The holder shall not accrue interest or OID.
- The market discount rules shall not apply.
- Any payment on the debt instrument, regardless of how designated, shall be treated as a return of the holder’s basis to the extent thereof, with any remaining portion being treated as a payment in retirement of the debt instrument.\(^{14}\)
- Definition of severely distressed debt instrument:
  - Any debt instrument acquired for a price not greater than the lesser of
    - 50 percent of the debt’s adjusted issue price, or
    - the present value of all remaining payments on the debt instrument, using a discount rate equal to the AFR at the time of purchase plus 15 percent;\(^{15}\)
  - Any publicly traded debt instrument whose trading price is less than the price described in the prior bullet point; and
  - Any other debt instrument for which the taxpayer has claimed a valid complete worthlessness deduction.

Codification of doubtful collectability doctrine (Option 3)

This option provides that no amount of yield be accrued if, at the time of the accrual, there is no reasonable possibility that the amount the holder will thereafter collect on the debt instrument will exceed the holder’s basis in the debt instrument.

Section 707(b)(1), rules similar to those in Section 267(a)(2) would apply, so that the issuer’s deductions for interest and OID would be limited to the amount the related holder includes in income.

\(^{14}\) Interest on any indebtedness incurred or continued to purchase or carry the severely distressed debt instrument would not be deductible and instead would be added to the basis of the severely distressed debt instrument. As in the case of the first option, in a case in which the issuer of the debt instrument is related to the holder within the meaning of Section 267(b) or Section 707(b)(1), rules similar to those in Section 267(a)(2) shall apply, so that the issuer’s deductions for interest and OID would be limited to the amount the related holder includes in income.

\(^{15}\) A higher threshold, and hence a narrower definition of severely distressed debt instrument, might be appropriate if both options are enacted, while a lower threshold (and hence a broader definition) would seem appropriate if the second option stands on its own as the only change to the tax treatment of distressed debt.
Accrual of market discount (Option 4)

This option provides that, if (and only if) one of the first two options is enacted, accrual-method holders of debt instruments would be required to include interest and discount in income as it accrues, regardless of whether the accrual is attributable to stated interest, OID or market discount. This option would remove distinctions between economically equivalent forms of interest and other amounts compensating for “the use or forbearance of money.” In so doing, it would make the market for debt instruments more efficient and would simplify the administration of the tax system. Because this change would be effective only in conjunction with one or both of the first two proposals, taxpayers should not be required to include in income any amount that does not represent a true economic accrual of income.

2. Change the character of losses on debt

Present law

Under current law, the character of loss on a debt instrument, including a deduction under the rules applicable to “bad” or “worthless” debt, depends on a number of factors, including (i) whether the debt is held as a capital asset, (ii) whether the debt is foreign-currency denominated or is a contingent payment debt instrument, and (iii) whether the bad debt expense rules apply.

In cases where debt is not held as a capital asset, any loss (including a bad debt expense deduction) is ordinary. Debt in this category includes (i) debt that is marked to market under Section 475 by a securities dealer or trader, (ii) debt held by certain financial institutions described in Section 582, (iii) trade or business receivables described in Section 1221(a)(4), and (iv) debt in the hands of certain loan originators and/or liquidity providers.

In cases where debt is held as a capital asset, realized loss generally is capital. If the loss arises from a sale or exchange, the loss is capital under Section 1222. If the loss arises from a retirement of all or part of the debt, the loss is deemed to arise from a sale or exchange under Section 1271 and is therefore capital.

In certain cases, special rules can apply to characterize realized loss as ordinary. If the debt instrument is foreign-currency denominated, realized loss is ordinary to the extent the loss is attributable to an unfavorable exchange-rate movement during the period the holder held the debt. If the debt instrument is a contingent payment debt instrument subject to the noncontingent bond method of Treasury Regulations Section 1.1275-4(b), realized loss is ordinary to the extent of net prior interest income from the debt instrument.


17 Section 475(d)(3).

18 Section 582(c)(1).

19 See Federal National Mortgage Association, 100 T.C. 541 (1993) (holding that mortgage loans acquired by the taxpayer on the secondary market were ordinary assets because the acquisition “enhance[d] the efficiency of the secondary market in mortgages” and therefore rendered a service in the taxpayer’s ordinary course of business); Burbank Liquidating Corporation, 39 T.C. 999 (1963), acq. 1965-2 C.B. 6, aff’d, 335 F.2d 125 (9th Cir. 1964) (holding mortgage loans made by a savings and loan association were “notes receivable acquired . . . for services rendered” and therefore ordinary assets).
Finally, in certain situations where debt is held as a capital asset, it is possible for a holder to take a Section 166 bad debt expense deduction in advance (or instead) of a realized capital loss. Under Section 166(a)(1), the holder of a debt instrument, even one held as a capital asset, can take a bad debt expense deduction (in an amount equal to its basis in the debt) if (i) the debt becomes wholly worthless during the year, (ii) the holder is a corporation (or if the holder is not a corporation, the debt is held “in connection with” the holder’s trade or business) and (iii) the worthless debt was either issued by an entity other than a government or a corporation or was not issued in registered form. Under Section 166(a)(2), a holder is entitled to a partial bad debt expense deduction with respect to unrealized loss in a debt instrument if (i) the three requirements above are met (substituting “partially” for “wholly”) and (ii) the same amount is “charged off” for financial accounting purposes.

Reasons for change

The present taxation of an investment in debt is inherently asymmetric from the holder’s perspective, in that most of the economic income from the debt instrument – whether interest, OID or market discount – is treated as ordinary income, while economic losses are generally capital. This imbalance can create a character whipsaw within a single debt instrument; for example, as discussed above in section II.A.1 of this submission, a holder may be required to accrue ordinary OID income over many periods and then suffer a corresponding capital loss if the debt instrument becomes impaired. For an investor that owns a pool of debt instruments but few other investment assets, the capital losses generated by the distressed debt instruments within the pool can often be completely unusable, resulting in distortive taxation of the holder’s income.

In practice, the bad debt expense rules often generate arbitrary results. The bad debt rules draw a critical distinction between widely available non-corporate debt, such as debt of a REMIC or of a limited partnership (generally eligible for the bad debt expense deduction), and economically similar debt of a corporation (generally not eligible). The distinction appears to be little more than an artifact of history—when the provision was originally drafted, Congress clearly meant to preclude bad debt expense treatment for “securities,” which Congress assumed were limited to registered-form corporate and governmental debt. Over the intervening decades, non-corporate issues have become more prevalent, due to the evolution of the asset-backed securities market, and therefore the bad debt expense deduction has become available for some instruments that are largely indistinguishable from “securities” of the type Congress intended to exclude from the bad debt rules.

There has also been an evolution in the “registered form” concept critical to the bad debt regulations. When originally enacted, the registered form requirement was likely designed to distinguish between true investment securities (typically in registered form and intended to be outside the scope of the bad debt provisions) and non-traded debt instruments (such as receivables or intercompany accounts) that were not typically in registered form. Through evolutions in the tax law definition of registered form and in market practice, registered form is no longer a reliable indicator of an investment security. Nowadays, many trade receivables and intercompany obligations appear to meet the “registered form” standard and, therefore, when issued by a corporation, are ineligible for the bad debt expense deduction.

An additional ambiguity regarding the scope of the bad debt expense provisions arises when an eligible debt is settled though a negotiated settlement (or a foreclosure where there is no deficiency claim by the creditor). In this case, the resultant loss can be viewed as either a realized loss from the retirement of the debt or a wholly worthless loss on the deficiency. At the time the bad debt rules were originally enacted, the rule (now in Section 1271) that deems a retirement to be a sale or exchange was limited to corporate and governmental obligations—the very obligations unlikely to be covered by the Section 166 bad debt rules. Since 1997, the deemed sale or exchange rule of Section 1271 applies to all debt, including debt that would otherwise be eligible for a bad debt expense deduction. The expansion of Section 1271 has created an issue as to whether a loss crystallized in a negotiated settlement ought to be characterized as a realized loss.
and therefore capital or as a wholly worthless deficiency and therefore a bad debt expense under Section 166. There are technical arguments and authorities supporting either result.

The rules governing the character of loss on debt instruments held as capital assets need to be rationalized and simplified. One idea is to expand the scope of the “recapture” character rule applicable to losses on contingent payment debt instruments. Under those regulations, realized losses on any particular contingent payment debt instrument are treated as ordinary to the extent of net prior interest inclusions from the instrument. This rule prevents an inappropriate character whipsaw (interest income, capital loss) on a single debt investment. This rule could be expanded to cover all debt instruments.

Finally, if the recapture character rule applies to all debt instruments held as capital assets, the bad debt expense rules could be modified to be consistent with the rules for other debt dispositions.

Options for Consideration

The option would amend Section 1271 to treat realized loss on a debt instrument held as a capital asset as ordinary loss to the extent of net prior ordinary income inclusions with respect to the debt. To address potential cherry-picking concerns, consideration could be given to limiting the taxpayer’s ordinary deductions with respect to debt losses for the taxable year to the taxpayer’s ordinary interest income and gains from debt for that year.

A further option would amend Section 166 to treat bad debt expense deductions as ordinary only to the extent that realized losses from a disposition of the debt instrument would be ordinary.

3. Modify “issue price” in debt-for-debt exchanges

Present law

Debt Modifications

Under current law, if the terms of a debt instrument are modified, the debt instrument in many cases will be treated for U.S. federal income tax purposes as if it were retired in exchange for a new debt instrument with the modified terms. An exchange is deemed to occur if, based on all the facts and circumstances, the legal rights or obligations that are altered by the modification, and the degree to which they are altered, are economically significant. Changes in the yield of a debt instrument or in the timing of payments, for example, may be considered economically significant, even though the principal amount of the debt remains the same. The conceptual underpinning of the relevant Treasury regulations on debt-for-debt exchanges, commonly known as the Cottage Savings regulations after the case that prompted their issuance, is that a realization event occurs when one asset is exchanged for another that is materially different.

20 Treas. Reg. § 1.1001-3(e)(1).
21 Treas. Reg. § 1.1001-3(e)(2) & (3).
From the issuer’s perspective, the U.S. federal income tax consequences of a debt-for-debt exchange under the Cottage Savings regulations depend primarily upon the issue price of the modified debt instrument. Specifically, Section 108(e)(10) of the Code provides that, for purposes of determining the issuer’s income from cancellation of debt (“COD income”), if a debt instrument is issued in satisfaction of another debt instrument, the issuer will be treated as having satisfied the existing debt for an amount of money equal to the issue price of the modified debt. Thus, the issuer will recognize COD income to the extent that the issue price of the modified debt instrument, determined as set forth below, is less than the adjusted issue price of the existing debt instrument, even if the principal amount of the debt is not reduced. Further, the issue price of the modified debt relative to its stated redemption price at maturity will determine whether it is treated as having been issued with OID, as well as whether the rules applicable to certain high yield debt instruments (the “AHYDO rules”) may defer or disallow the interest expense deductions attributable to the OID. Thus under current law, a debt workout commonly results in adverse timing consequences to the issuer in the form of current COD income on the existing debt, with OID deductions over the term of the modified debt, and in some cases a permanent difference where the AHYDO rules apply to disallow the OID deductions.

The issue price of the modified debt also generally determines the amount realized in a debt-for-debt exchange by the holder of the existing debt, and whether the holder will be required to recognize additional interest income as a result of OID. Regardless of the tax consequences of the exchange to the issuer (e.g., COD income), any gain or loss realized by the holders may be deferred if both the existing debt and the modified debt are “securities” and the deemed exchange constitutes a recapitalization under the tax-free reorganization rules of Section 368(a). In that case, if the holder bought the debt for less than its principal amount in the secondary market, the deemed exchange generally will turn the market discount on the debt, which would have been recognized only upon disposition or repayment, into OID required to be recognized as it accrues. On the other hand, if the holder has a high basis in the existing debt instrument, the holder’s realized loss is not recognized in a reorganization. Although the modified debt will be treated as issued with OID, the holder’s high basis in the debt generally will offset the OID as it accrues. If the deemed exchange does not qualify as a reorganization, the holder’s gain or loss is fully recognized, including potentially the recognition of phantom gain to the extent that the issue price of the modified debt exceeds the holder’s basis in the existing debt. The gain generally is

24 Section 1273; Treas. Reg. § 1.1273-1.
25 Section 163(e)(5) & (i).
26 Reorganization treatment is available only if the issuer is a corporation and both the existing debt and the modified debt constitute securities for U.S. federal income tax purposes. Section 354(a). The determination of whether a debt instrument is a security for this purpose depends on all the facts and circumstances, but the term of the instrument is considered an important factor. Very short-term instruments tend to be less likely to be treated as securities because they do not represent an interest in the fortunes of the issuer.
27 Section 1276(a). One option described above would provide that market discount is required to be currently accrued by accrual method taxpayers if, and only if, one of our main proposals with respect to distressed debt is adopted.
28 Sections 171 & 1272(a)(7).
29 Any loss may be subject to deferral under the wash sale rules. See section 1091(a).
reportable under the installment method, but may be subject to an onerous deferred interest charge under Section 453A.

**Determination of issue price and amount of COD income**

Under current law, the issue price of a debt instrument issued (or deemed to be issued) in exchange for another debt instrument depends upon whether the existing debt or the modified debt is publicly traded. If the modified debt is publicly traded, the issue price of the debt is its fair market value on the issue date.\(^{30}\) If the modified debt is not publicly traded, but the existing debt is publicly traded, the issue price of the modified debt is the fair market value of the existing debt on the issue date of the modified debt.\(^{31}\) If neither the existing debt nor the modified debt is publicly traded, then the issue price of the modified debt is its stated redemption price at maturity if the debt bears adequate stated interest, generally based on the AFR.\(^{32}\) If the modified debt does not bear adequate stated interest, then its issue price is an imputed principal amount, using the AFR as the discount rate.\(^{33}\)

The practical result of the rules for determining issue price is that the issuer will recognize COD income on modifications of publicly traded debt in any case where the issuer’s creditworthiness has declined or market interest rates have risen, because the existing debt will be treated as satisfied for an amount of cash equal to the lower fair market value of the modified debt. Under current law, this result ensues even if the principal amount of the debt has not changed, so that the issuer remains legally liable for the full face amount of the debt. In contrast, if the modified debt is not publicly traded, its issue price generally will be equal to the face amount of the debt and the issuer will not recognize any COD income, as long as the debt bears adequate stated interest.

**Definition of publicly traded**

Under current law, a debt instrument is treated as publicly traded if, at any time during the 60-day period ending 30 days after the issue date, the debt instrument is, among other things, listed on a U.S. national securities exchange or certain foreign exchanges, or:

- it appears on a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders) that provides a reasonable basis to determine fair market value by disseminating either recent price quotations (including rates, yields, or other pricing information) of one or more identified brokers, dealers, or traders or actual prices (including rates, yields, or other pricing information) of recent sales transactions (a quotation medium).\(^{34}\)

\(^{30}\) Section 1273(b)(3)(A); Treas. Reg. § 1.1273-2(b).

\(^{31}\) Section 1273(b)(3)(B); Treas. Reg. § 1.1273-2(c).

\(^{32}\) Sections 1273(b)(4) & 1274(a)(1); Treas. Reg. §§ 1.1273-2(d)(1) & 1.1274-2(b)(1).

\(^{33}\) Section 1274(a)(2); Treas. Reg. §§ 1.1273-2(d)(1) & 1.1274-2(b)(2).

\(^{34}\) Treas. Reg. § 1.1273-2(f)(4). A debt instrument also would be considered publicly traded if it was listed on an interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Exchange Act of 1934, was property of a kind that is traded either on a board of trade designated as a contract market by the Commodities Futures Trading Commission or on an interbank market or if price quotations were readily available from dealers, brokers, or traders, subject to certain safe harbors.
Issuers and their advisors have found it very difficult to conclude that particular debt instruments are not publicly traded under this definition, especially given the myriad technological advances that have expanded the availability of pricing information. A consensus view has developed among practitioners that debt issuances appearing on the “Trade Reporting and Compliance Engine” (“TRACE”) website of the Financial Industry Regulatory Authority are publicly traded under this definition, since actual trading prices as well as limited trade history are presented. TRACE covers only debt that is registered with the Securities and Exchange Commission, but pricing information for many unregistered issuances, including some bank loans, is available from other electronic sources.

In recently issued proposed regulations, Treasury and the Service have taken a broad view of the meaning of publicly traded for purposes of determining the issue price of debt instruments, on the grounds that the improved depth and transparency of the debt markets have diminished concerns that the trading prices of debt instruments may not reflect their fair market value. Thus, the preamble states, "to the extent accurate pricing information exists, whether it derives from executed sales, reliable price quotations, or valuation estimates that are based on some combination of sales and quotes, the Treasury Department and the Service believe that that information should be the basis for the issue price determined under section 1273(b)(3)." Under the proposed regulations, property would be considered publicly traded if, during the 31-day period ending 15 days after the issue date of the debt instrument (i) the property is listed on an exchange, (ii) a sales price for the property is reasonably available, (iii) there are one or more firm quotes for the property, or (iv) there are one or more indicative quotes for the property.

Directionally, the proposed regulations mean that even more debt instruments will be considered publicly traded, and therefore even more issuers will face the risk of recognizing significant amounts of COD income if their debt is modified.


Reasons for change

COD income

The substitution of one debt obligation of an issuer for another obligation with modified terms but the same principal amount generally is not an appropriate occasion for the recognition of COD income by the issuer or the imposition of tax. The Cottage Savings rationale for treating a significant debt modification as a taxable event is that one asset has been exchanged for a materially different asset. This rationale may make perfect sense where the new asset is cash or widgets or even stock of the issuer, because afterward the issuer is no longer liable to repay the indebtedness for which the new asset was exchanged. The issuer and the holder are in very different positions after the exchange, and there is no particular reason not to give the exchange tax effect.

Contrast this with a debt-for-debt exchange where the principal amount is not reduced: The holder’s investment in the issuer continues in the modified form, and it is clear as a matter of common sense that the issuer still owes the same amount of money to the holder. The fact that the debt may be worth less than its principal amount at the time of the modification does not change

36 Id.
37 The proposed regulations provide exceptions to the expanded definition of publicly traded for certain de minimis trading and small issuances.
the issuer’s legal obligation to repay the principal amount. Consistent with that legal obligation, the holder’s claim against the issuer in bankruptcy generally would be the principal amount of the debt.\textsuperscript{38} Further, absent the application of the AHYDO rules discussed below, the current recognition of COD income generally should be reversed by future deductions of OID in the same amount, which begs the question of whether it is worth requiring the COD income to be recognized in the first place.

The issue price rules for publicly traded debt instruments adopt the fiction that the issuer has raised cash proceeds from the issuance of the modified debt for its fair market value, which it uses to fully retire the existing debt. This fiction ignores the continuity of the holder’s investment in the issuer (\textit{i.e.}, that the debt has not actually been retired). It also ignores the economic reality that debt modifications typically are undertaken when the debtor is having financial difficulties and likely would be hindered from raising new money in the capital markets. Further, unless the debtor can exclude the COD income because of bankruptcy or insolvency (which the debtor may have been trying to avoid by restructuring its debt), or has available net operating losses to fully offset the COD income, the result under current law for modifications of publicly traded debt will only exacerbate the troubled debtor’s situation.

In adopting Section 108(i) as part of the American Recovery and Reinvestment Act of 2009,\textsuperscript{39} Congress sought to mitigate the problem of COD income in debt workouts by adopting a temporary deferral election for COD income realized in 2009 or 2010 upon the reacquisition, exchange or modification of any debt instrument issued by a C corporation, or any other person in connection with the conduct of a trade or business. The deferral period is five tax years for transactions in 2009 and four tax years for transactions in 2010, after which the COD income must be recognized ratably over a period of five tax years. If the transaction included the issuance (or deemed issuance) of a new or modified debt instrument in exchange for the outstanding debt, deductions with respect to any OID on the new debt are deferred for the same four- or five-year period,\textsuperscript{40} and are then taken into account ratably over the five-year recognition period for the COD income. Section 108(i) was only a temporary solution, which is inapplicable to debt exchanges and modifications after 2010.

Prior to its 1990 repeal, Section 1275(a)(4) had established a floor for the issue price of a debt instrument issued in a debt-for-debt exchange pursuant to a plan of reorganization under Section 368(a): The issue price of the modified debt could not be less than the adjusted issue price of the existing debt for which it was (or was deemed to be) exchanged. Further, common law principles, to which the courts, the Service and most practitioners adhered, indicated that the reference point for determining the amount of COD income on a debt-for-debt exchange was the principal amount of the existing and modified debt, rather than its fair market value.\textsuperscript{41} There was

\textsuperscript{38} \textit{In re Chateaugay Corp.}, 961 F. 2d 378 (2d Cir. 1992) (overturning holding of lower court that allowable bankruptcy claim is limited to fair market value of new debt on exchange date).

\textsuperscript{39} American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, Section 1232(a) & (c).

\textsuperscript{40} OID deductions exceeding the amount of the deferred COD income are not deferred.

a concern, however, that a literal reading of Section 1275(a)(4) permitted COD income to be
avoided where the principal amount of the modified debt was reduced. The purported result under
this literal application of the statute was the creation of bond premium on the modified debt
instead of COD income. This issue, as well as other forms of selective taxpayer avoidance of
Section 1275(a)(4) in order to trigger COD income and OID, apparently precipitated the abrupt
repeal of Section 1275(a)(4) less than three weeks after a proposal to do so was publicly released.

It is not clear that the issues articulated with respect to Section 1275(a)(4) warranted its
outright repeal. For example, the concern about the avoidance of COD income where the
principal amount of the modified debt is reduced could be readily addressed by including language
in the statute preventing this result, such as the language proposed below. Further, the particular
forms of selectivity under Section 1275(a)(4) have merely been replaced by different strategies
selectively employed by issuers under current law. These new forms of selectivity will be
prevented if our issue price proposal is adopted. For example, under current law, an issuer with
publicly traded debt trading at a discount may be able to refresh its NOLs by modifying its debt in
a manner sufficient to trigger a deemed exchange under the Cottage Savings regulations,
recognizing COD income against its existing NOLs and being treated as issuing the modified debt
with deductible OID (again assuming no limitations on deductibility). Conversely, an issuer with
publicly traded debt trading at a premium may trigger an exchange in order to deduct that
premium. The point is that selectivity is not necessarily a reason for or against treating a debt
modification as a taxable event.

Further, if the option identified below is adopted and a debt modification generally is not
a taxable event, the most obvious strategies to avoid that result are susceptible to challenge under
general step transaction principles. For example, if an issuer were to agree with its current debt
holders to issue modified debt for cash and immediately use the proceeds to satisfy the old debt at
a discount in order to refresh its NOLs, the separate steps might not be respected under general
step transaction principles. Anti-abuse rules could be promulgated as necessary to combat this and

No Cancellation of Debt Income in Section 1275(a)(4) Cases, 47 Tax Notes 1247 (June 4, 1990);
Lipton, Howard, Rice, Nemerovski, Canady, Robertson & Falk, to Robert Scarborough,
Department of the Treasury, and Tom Wessel, Office of the Chief Counsel of the IRS (Sept. 25,
1990), available at 90 TNT 210-63.

42 For example, because Section 1275(a)(4) applied only to a reorganization within the
meaning of Section 368(a), an issuer could avoid the statute by issuing a debt instrument that was
not a security for such purposes, or by having an affiliate make the exchange, and trigger COD
income to refresh its net operating losses by using currently those that might expire and creating
new NOLs from the resulting OID deductions (assuming none of the provisions that would limit
those deductions, such as the AHYDO rules, applied).

43 Both the New York State Bar Association and the American Bar Association Tax
Section previously have recommended reinstatement of Section 1275(a)(4) in some form. See
New York State Bar Association Tax Section Report of Ad Hoc Committee of Provisions of the
Revenue Reconciliation Act of 1990 Affecting Debt-for-Debt Exchanges, 91 TNT 69-37 (Mar. 25,
1991); The Case for Reinstatement and Expansion of Section 1275(a)(4), 94 TNT 9-60 (Jan. 10,
1994).

44 Treas. Reg. § 1.163-7(c).
similar strategies. It may be appropriate, for instance, to apply the proposed non-recognition rule even where the principal amount of the debt is reduced if this reduction is coupled with an increase in interest rate intended to replicate the overall return to the holders (albeit shifting principal to interest).

AHYDO

As noted above, under current law, a workout of publicly traded debt commonly results in adverse timing consequences to the issuer in the form of current recognition of COD income on the existing debt, with OID deductions over the term of the modified debt. In many cases, however, it is not even possible for an issuer to deduct the OID resulting from the deemed exchange, because of the application of the AHYDO rules. Thus, the tax consequences of a modification of publicly traded debt are not merely timing issues of current recognition of COD income by the issuer coupled with OID deductions of the same gross amount over the term of the debt. Instead, under current law, it frequently is the case that the interest expense deductions for the associated OID are disallowed entirely under the AHYDO rules.

The AHYDO rules apply to any debt instrument issued by a corporation that has a term of more than five years, a yield to maturity of at least the AFR in effect at issuance plus five percent, and “significant OID.” Very generally, a debt instrument has significant OID if more than one year’s worth of yield on the debt instrument (including interest and OID) remains unpaid at the end of any accrual period ending after the date five years from the issue date. The AHYDO rules are extremely complex in their application, but suffice it to say that many debt modifications implicate the rules because the modified debt is treated as newly issued and its issue price is based on the public trading price, which in almost all debt restructurings will be at a discount to the stated redemption price at maturity.

If the yield on the modified debt instrument does not exceed the relevant AFR by more than six percent, the AHYDO rules merely defer the deductions attributable to the OID until payment is made (other than payment-in-kind in the form of other debt or stock of the issuer or a related party). If the yield does exceed the AFR plus six percent, however, a portion of the total yield on the debt is not deductible at all. During the economic downturn of 2008, Congress recognized the difficulty of this result for financially troubled debtors and provided temporary relief from the AHYDO rules for many debt modifications, but this relief expired at the end of 2010. Thus, debtors who modify their publicly traded debt run the risk not only of recognizing

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45 Section 163(i)(1). The AHYDO rules also apply to debt issued by a partnership to the extent attributable to corporate partners. Treas. Reg. § 1.701-2(f), Ex. 1.

46 Section 163(i)(2).

47 Section 163(e)(5)(A)(i). The disqualified portion of the OID is treated as a distribution eligible for the dividends-received deduction for corporate holders as it accrues. Section 163(e)(5)(A)(ii).

48 American Recovery and Reinvestment Act of 2009, Section 1231(a). During the downturn, corporate bond spreads rose to extremely high levels, resulting in large numbers of bonds, including investment grade, with yields in excess of the AFR by 6 percent or more. See, e.g., Serena Ng, In Bad Year for All, Bonds Suffer Most, Wall. St. J., November 22, 2008 at B3 (“Investment-grade corporate bonds on average now yield roughly 9%—about six percentage points more than Treasurys. . . . Junk-bond spreads, meanwhile, have surged to 19.5 percentage points . . . .”).
COD income but also the disallowance of the associated OID deductions, resulting in a permanent mismatch.

**Divergent holder consequences depending on reorganization status**

Under current law, the tax consequences of a debt modification to the holder depend heavily on whether the deemed exchange resulting from the modification qualifies as a reorganization within the meaning of Section 368(a) of the Code. Status as a reorganization depends in turn on whether the debtor is a corporation, and whether the debt instruments constitute “securities” for purposes of the reorganization rules.\(^{49}\) If the exchange constitutes a reorganization, then regardless of the tax consequences of the exchange to the issuer (such as COD income), the holder does not recognize gain or loss, and takes a carryover basis in the modified debt. If the exchange does not constitute a reorganization, either because the debtor is not a corporation or the debt instruments are not securities, gain or loss is recognized fully by the holder. In cases where the issue price of the modified debt instrument is determined based on its principal or imputed principal amount rather than on public trading,\(^{50}\) a holder that purchased the debt at a discount may be required to recognize a large amount of phantom gain.

As noted above, we do not view the substitution of one debt obligation of an issuer for another obligation of that issuer with modified terms, where the principal amount stays the same, as an appropriate occasion for the recognition of gain or loss or the imposition of tax. There is no clear policy rationale for limiting holder non-recognition treatment to obligations of corporate debtors, or to debt instruments that constitute securities for purposes of the reorganization rules. Many large business enterprises are organized in non-corporate form, and in most respects are indistinguishable from corporations in terms of size, complexity and creditworthiness. In addition, the term “security” is not defined in the Code or in Treasury regulations, nor has it been clearly defined by judicial decisions. In general, a debt instrument is a “security” for these purposes if, based on all the facts and circumstances, the debt instrument constitutes a continuing investment in the issuer.\(^{51}\) One of the most important factors that may affect the determination of whether a debt instrument is a “security” is the original term of the instrument. Many practitioners consider a term exceeding five years to be particularly relevant to this determination.\(^{52}\) Under the substitution of obligation theory, however, the relevance of the original term of the existing debt instrument is quite attenuated, particularly where the debt is publicly traded and the holder may have acquired it only a short time before the deemed exchange. The remaining term of the existing debt and the term of the modified debt are of much greater significance economically to both the issuer and the holder. The distinctions between corporate and non-corporate debtors and between securities and non-securities are arbitrary, and give rise to divergent tax consequences for no apparent policy reason. Extending non-recognition treatment to all debt modifications would rationalize the tax consequences of similar transactions.\(^{53}\)

\(^{49}\) See supra footnote 26.

\(^{50}\) See supra footnote 28-31.

\(^{51}\) Camp Wolters Enterprises, Inc. v. Comm’r, 230 F.2d 555 (5th Cir. 1956), cert. denied, 352 U.S. 826 (1956).

\(^{52}\) The IRS stated in Rev, Rul. 2004-78, 2004-31 I.R.B. 108 (8/2/2004), that “[u]nder case law, an instrument with a term of less than five years generally is not a security.”

\(^{53}\) The option focuses on situations in which principal is reduced or stays the same, as would ordinarily be the case in a debt restructuring. As under current law in the context of a (...continued)
In addition, nonrecognition treatment will tend toward symmetry between the issuer and holder in any particular exchange because, unless the principal amount is reduced, neither the issuer nor the holders will recognize gain or loss. Under current law, there frequently is divergence between the current tax consequences of a debt workout to the issuer and the holder: If the issue price of the modified debt is less than the adjusted issue price of the existing debt, such as where the debt is publicly traded, the issuer generally will recognize COD income, but if the exchange constitutes a reorganization under Section 368(a) of the Code, any gain or loss realized by the holder will be deferred. Conversely, if the issue price of the modified debt equals or exceeds the issue price of the existing debt, such as where the debt is not publicly traded, the issuer will not recognize COD income, but if the exchange does not constitute a reorganization, the holder generally will recognize phantom gain to the extent that the issue price of the modified debt exceeds the holder’s basis in the existing debt. As noted in the options on distressed debt in section I.A above, matching or symmetry between the issuer and holders does not always make sense, such as triggering income or loss to the issuer based on secondary market trading between holders. Where the issuer and the holders are counterparties to the same transaction, however, consistent treatment of the transaction as a non-recognition event for both parties generally would be sensible. We note, however, that symmetry breaks down in cases where the principal amount is reduced. Whereas the issuer clearly should recognize COD income, since its legal obligation to repay the principal has been reduced, the holder may or may not have realized a loss from the reduced principal amount, depending on such factors as the holder’s basis in the debt and its value at the time of the reduction in principal. We therefore have not presented the option of permitting the recognition of the holder’s loss in cases where the issuer recognizes COD income because of a reduction in principal amount.

Option for Consideration

The statute could provide that, in a debt-for-debt exchange in which the issuer of the debt does not change, including a deemed exchange under Treasury Regulations Section 1.1001-3 resulting from a modification, the issue price of the modified debt is equal to the lesser of (x) the adjusted issue price of the existing debt, or (y) the issue price of the modified debt determined under Section 1274, regardless of whether the debt would be considered publicly traded. Thus, under (y) the issue price would be the stated principal amount if the modified debt bears adequate stated interest, or the imputed principal amount if it does not.\(^4\) This formulation generally would avoid the recognition of COD income by the issuer if the principal amount of the modified debt is not reduced and the debt has adequate stated interest, but would address certain of the issues that led to the repeal of Section 1275(a)(4), including requiring recognition of COD income where the principal amount is reduced.

Further, from the holder’s perspective, the exchange should be a non-recognition transaction with carryover basis, regardless of whether it otherwise would constitute a reorganization within the meaning of Section 368(a) of the Code (\textit{i.e.,} regardless of whether the issuer is a corporation and the debt is a security). Therefore, a holder with basis in the existing debt that is less than the issue price of the modified debt would not be required to recognize phantom gain as a result of the deemed exchange, and a holder with basis in the existing debt that

\(^{54}\) Sections 1273(b)(4) & 1274(a)(1); Treas. Reg. §§ 1.1273-2(d) & 1.1274-2(b)(1); Section 1274(a)(2); Treas. Reg. §§ 1.1273-2(d) & 1.1274-2(b)(2).
exceeds the issue price of the modified debt would not be permitted to recognize loss, and there would be no arbitrary distinctions between workouts undertaken by corporate versus non-corporate debtors or between debt instruments that are securities versus debt instruments that are not.

4. **Repeal of Section 279**

Present law

Section 279 disallows interest deductions on “corporate acquisition indebtedness” (“CAD”). In general, CAD is indebtedness of an issuer corporation: (i) issued to provide direct or indirect consideration to acquire stock, or two-thirds or more of the business assets, of another corporation, (ii) that is subordinated to certain other indebtedness of the issuer, and (iii) that is convertible directly or indirectly into stock of the issuer (or that is part of an investment unit or other arrangement that includes an option to acquire directly or indirectly stock in the issuer), if, on specified dates, the issuer has either (x) a ratio of debt to equity that is higher than 2:1 or (y) a ratio of “projected earnings” to annual interest that is 3:1 or lower. An issuer’s annual interest deductions on CAD are limited to: (i) $5 million minus (ii) the amount of interest paid or accrued during the year on non-CAD obligations that were issued to finance acquisitions of another corporation’s stock or two-thirds or more of its business assets.

An obligation is treated as providing direct consideration for an acquisition if it is issued to the shareholders of the target corporation in exchange for their equity interests in the target. An obligation is treated as providing indirect consideration for an acquisition of stock or assets if: (i) at issuance, the issuer “anticipated the acquisition of such stock or assets and the obligation would not have been issued” if the issuer had not anticipated the acquisition or (ii) at the time of the acquisition, the issuer “foresaw or reasonably should have foreseen that it would be required to issue obligations to meet its future economic needs.”

To fall within the “subordination” prong in the definition of CAD, the acquisition indebtedness must be either: (i) subordinated to the claims of the issuer’s trade creditors generally or (ii) expressly subordinated to the payment of any substantial amount of unsecured indebtedness. In general, Section 279 is applied by treating all members of an affiliated group in the aggregate as the issuer of the obligation; however, the target corporation is not treated as a member of the issuer’s affiliated group for this purpose.

There are detailed rules for calculating the debt/equity and projected earnings/annual interest ratios. These ratios are tested as of the last day of the issuer’s taxable year when it has issued debt to finance acquisitions of stock, or two-thirds or more of the business assets, of another corporation. Under certain circumstances, these ratios must be re-tested in subsequent

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55 Section 279(b).
56 Treas. Reg. § 1.279-3(b)(2).
57 Section 279(b)(2); Treas. Reg. § 1.279-3(c).
58 Section 279(g).
59 Section 279(c)(1).
The debt/equity ratio is a relatively straightforward calculation: the ratio of the total indebtedness of the issuer over the sum of its money and the adjusted basis of its other assets. However, determining the projected earnings/annual interest ratio requires more complex calculations. In addition, there are special rules for applying these tests to issuers that are financial institutions.

If an issuer extends, renews or refinances CAD, the refinanced obligation will be CAD, even if the refinanced obligation does not satisfy the four prongs in the definition of CAD (e.g., if the refinanced obligation is not convertible into stock of the issuer). However, a different result may obtain if an issuer issues obligations that are not CAD (e.g., bank debt) to acquire stock of another corporation and then later repays those obligations with newly-issued subordinated, convertible debt. In that case, the Service under certain facts has privately ruled that the newly-issued obligations are not CAD.

There are a number of exceptions to Section 279. For example, obligations that are issued in tax-free stock acquisitions or in acquisitions of the stock or assets of a foreign corporation are generally not subject to interest disallowance under Section 279. In addition, Section 279 does not apply to obligations that are issued by a corporation to acquire its own stock.

**Reasons for change**

Congress enacted Section 279 in 1969, at a time when many corporate acquisitions were financed by the issuance of convertible bonds. Congress was concerned that certain corporate bonds more closely resembled equity, rather than indebtedness, for U.S. federal income tax purposes. Congress believed that bonds issued in connection with an acquisition of a target corporation were particularly suspect, as the selling shareholders were substituting bonds of the

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60 For example, if a corporation has issued an obligation that is treated as CAD, but the obligation would not be treated as CAD if tested as of the end of three subsequent consecutive years, the obligation will no longer be subject to the interest disallowance rule of Section 279. See Section 279(d)(4).

61 Section 279(c)(5).

62 See Section 279(h)(1).

63 G.C.M. 39618 (Mar. 30, 1987) (“Section 279(h)(1) provides that a refinancing of an existing debt shall not be deemed to be the issuance of a new obligation. Thus, section 279(h)(1) deems a refinancing obligation a continuation of the old obligation whose issuance dates back to the issuance of the old obligation. . . . In short, if the old obligation evidencing the debt being refinanced is not corporate acquisition indebtedness, then the obligation issued to refinance it is not corporate acquisition indebtedness either.”).

64 See Section 279(e) & (f).

65 See Section 279(b)(1) (the Section 279 rules may apply to an obligation that “is issued to provide consideration for the acquisition of . . . stock in another corporation”) (emphasis added).

66 H.R. Rep. No. 413, 91st Cong., 1st Sess., 104 (Aug. 2, 1969) (“The committee does not believe that many corporate bonds and debentures which presently are being treated as debt are, in fact, debt rather than equity.”).
acquirer for their equity holdings in the target. Such substitution, Congress believed, was easier to bring about at the time of a merger because the selling shareholders were more willing to hold debt of the acquiring corporation than would be a more sophisticated creditor.

The concerns that gave rise to the enactment of Section 279 are not very relevant to many convertible debt instruments issued in today’s capital markets, particularly convertible debt issued for cash. The rules for determining whether an obligation is CAD are complex and often difficult to apply, and therefore consume time and resources even when, as is very typically the case in convertible debt issued into the capital markets, an exception to the application of Section 279 ultimately applies. Finally, the Code contains other provisions capable of dealing with concerns about equity-like debt, including the applicable high yield discount obligation (“AHYDO”) rules and Section 385. In particular, Section 163(l), enacted in 1997, addresses certain significant concerns about present-day debt with equity-like features in a manner that is more effective than that of Section 279.

In modern capital markets, convertible debt is used by corporations to obtain relatively inexpensive financing. Although these offerings can be SEC-registered, convertible debt is frequently issued to qualified institutional buyers under Rule 144A of the Securities Act of 1933. Corporations use the cash proceeds of these offerings for many purposes, including to fund acquisitions of other corporations.

In this context, Congress’ original concerns about the use of convertible debt to make acquisitions do not seem warranted. While Congress was concerned about unsophisticated selling shareholders being influenced by the possibility of an acquisition to accept equity-like debt, modern convertible debt investors are generally sophisticated, independent investors not otherwise involved in the potential corporate acquisition, and are paying cash for their bonds.

In addition to no longer addressing Congress’s original concerns, the Section 279 rules are flawed in various respects. Depending on the relevant facts, Section 279 can require a subjective determination regarding the issuer’s intent; it can apply in an inappropriately broad fashion; the resources required to make a determination under Section 279 can be significant; and, because certain determinations under Section 279 are made post-issuance, the provision can impede rational planning.

The application of the Section 279 rules to a potential convertible debt offering is often subjective. For example, an investigation into the issuer’s intent is required when testing whether an obligation is issued indirectly “to provide consideration” for the acquisition of stock of another


68 *Id.*


71 In our experience, hedge funds and other institutional investors such as mutual funds are the typical investors in a convertible bond offering.
corporation. Pursuant to regulations, the relevant test is whether the issuer “anticipated the acquisition” and the obligation “would not have been issued” if the issuer had not anticipated the acquisition.\(^{72}\) Similarly, where an obligation is issued after the acquisition of the stock of another corporation, the relevant test is whether the issuer “foresaw or reasonably should have foreseen that it would be required to issue” the obligation.\(^{73}\) Intent-based rules can be difficult to apply in practice.

The Section 279 rules can also be a trap for the unwary. If a corporation issues a non-convertible debt obligation and warrants on its stock in a single transaction, the debt obligation may be CAD even though it is not convertible.\(^{74}\) As a result, corporations that issue relatively low-value warrants on their equity—sometimes referred to as “equity kickers”—to lenders in financing transactions must be mindful of the Section 279 rules.

The “subordination” prong of Section 279 has an unduly broad reach in the holding company context. For reasons unrelated to taxation, public corporate groups frequently issue debt at the parent corporation level while carrying on their business activities at the level of one or more operating subsidiaries. Because Section 279 requires an analysis based on the entire consolidated group, all debt of the parent corporation in a pure holding company structure will be treated as subordinated, because it is structurally subordinated to trade creditors of the operating subsidiaries. While the Service has acknowledged that such a result was not intended and has issued private letter rulings mitigating this potentially harsh result, those rulings were not public and were limited to specific facts.\(^{75}\)

Furthermore, because the debt/equity and projected earnings tests must be carried out on a date after the issuance of the convertible debt, planning can be difficult. In effect, an issuer must make decisions based on an estimate, up to a year in advance, about its earnings and debt/equity ratio, and risks losing its interest deductions if a market downturn causes those estimates to be wrong.

As a practical matter, in our experience, Section 279 almost never ends up applying to a convertible debt instrument issued in the capital markets because one of the many exceptions applies.\(^{76}\) Nonetheless, determining whether Section 279 applies can consume substantial time

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\(^{72}\) Treas. Reg. § 1.279-3(b)(2).

\(^{73}\) Treas. Reg. § 1.279-3(b)(2).

\(^{74}\) See Section 279(b)(3)(B) (including as CAD any bond that is “part of an investment unit or other arrangement which includes…an option to acquire, directly or indirectly, stock in the issuing corporation”). However, the Service has ruled that Section 279 would not apply if the issuer issued common stock (rather than a warrant) to the lender in connection with the financing transaction. See P.L.R. 8810001 (Oct. 1, 1987).

\(^{75}\) See P.L.R. 8640073 (July 10, 1986); P.L.R. 8337018 (June 9, 1983); P.L.R. 8336009 (June 9, 1983).

\(^{76}\) In the rare case where Section 279 will apply to a proposed convertible bond offering, in our experience the issuer would choose an alternative transaction (e.g., high yield debt) that is not subject to Section 279 rather than proceed with the proposed convertible bond offering.
and resources. For example, to calculate the debt/equity ratio for a corporate group, the group must determine the basis for each of its assets, information that is not always readily available.77

Finally, other provisions of the Code are better suited for dealing with the types of equity-linked debt instruments that are issued in today’s markets. Section 163(l), which was enacted in 1997, denies interest deductions under certain circumstances on indebtedness if a substantial amount of the principal or interest of the indebtedness is payable in, or determined by reference to, equity of the issuer or a related party.78 The stated purpose for enacting Section 163(l) was similar to the purpose for enacting Section 279: Congress believed that corporate taxpayers were issuing obligations denominated as debt but that “closely resemble[d] equity.”79 The operative rules for determining when indebtedness is subject to Section 163(l) are not as technically complex as the rules under Section 279, and do not require numerical calculations. In addition, Section 163(l) contains an important carve out for convertible debt instruments that are commonplace in the current marketplace—debt instruments that are convertible only at the holder’s option and that have, at issuance, a strike price that is significantly higher than the issuer’s stock price at issuance. Under Section 163(l), a debt instrument that is convertible only at the option of the holder (i.e., a debt instrument where the issuer cannot require the holder to accept stock as payment of a substantial amount of the principal or interest) would not be subject to Section 163(l) unless the conversion into stock is “substantially certain.”80 Accordingly, as long as there is not a “substantial certainty the option will be exercised,” Section 163(l) generally would not apply to a plain-vanilla convertible debt instrument. Section 163(l) and Section 279 share a common purpose — preventing issuers from taking interest deductions on obligations that Congress believed too closely resembled equity — but Section 163(l) is better tailored to the current convertible debt market. It excludes from its application ordinary convertible debt but applies to instruments where receipt of equity is certain or very likely; we believe that this distinction is an appropriate one.

The AHYDO rules and Section 385 further deal with debt instruments that have an equity flavor. In 1989, Congress added the AHYDO rules of Section 163(e)(5) and Section 163(i), which defer (and in some cases permanently disallow) a portion of the interest deductions attributable to certain high-yield instruments with original issue discount.81 In the same legislation, Congress

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77 If the issuer has issued CAD, it may expend substantial time and effort to comply with the rules applicable to CAD. For example, the CAD rules may apply to such an issuer with respect to future indebtedness issued by the issuer in a refinancing (even if that indebtedness would not otherwise satisfy the four prongs of the definition of CAD). If an issuer repays its CAD with cash and then later issues new, non-convertible debt, it is possible that the non-convertible debt might be treated as CAD under the refinancing rules. David Garlock, Federal Income Taxation of Debt Instruments ¶ 606.09(C) (6th ed. 2010) (“[O]ne issue not fully explored is how separated new debt must be to avoid being classified as a refinancing of other debt subject to section 279.”).

78 Taxpayer Relief Act of 1997, Pub. L. No. 105-34, Section 1005.

79 Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997, 193 (Dec. 17, 1997).

80 In addition, the legislative history to Section 163(l) indicates that a plain-vanilla optionally-convertible debt instrument should not be subject to Section 163(l) if the conversion price of the instrument is “significantly higher than the market price of the stock on the issue date of the debt.” H.R. Rep. No. 148, 105th Cong., 1st Sess., 458 (1997).

also amended Section 385(a) to give Treasury the authority to treat interests in a corporation as partially debt and partially equity. 82 Viewed as a whole, these provisions, Section 163(l) and the extensive body of case law on the debt-equity distinction 83 are fully capable of addressing concerns about equity-like convertible debt, rendering Section 279 unnecessary.

Option for Consideration

Under the option, Section 279 would be repealed.

B. Character of Gain and Loss on Derivatives

1. Update and clarify Sections 1234 and 1234A

Present Law

Section 1234(a)

Under section 1234(a), gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, an option to buy or sell property is considered gain or loss from the sale or exchange of property that has the same character as the property to which the option relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him). This rule does not apply to (A) an option that meets the inventory or stock in trade characterization of Section 1221(a)(1); (B) in the case of gain attributable to the sale or exchange of an option, any income derived in connection with such option that, without regard to that subsection, is treated as other than gain from the sale or exchange of a capital asset; and (C) a loss attributable to failure to exercise an option described in Section 1233(c). For purposes of applying the rule in Section 1234(a), if a loss is attributable to failure to exercise an option, the option shall be deemed to have been sold or exchanged on the day it expired. Additionally, under Section 1234(b), in the case of the grantor of the option with respect to “property,” gain or loss from any closing transaction 84 with respect to, and gain on lapse of, an option in property is treated as a gain or loss from the sale or exchange of a capital asset held not more than one year. For purposes of Section 1234(b), the term “property” means stocks and securities (including stocks and securities dealt with on a “when issued” basis), commodities, and commodity futures. However, Section 1234(b) does not apply to any option granted in the ordinary course of the taxpayer’s trade or business of granting options. Finally, Section 1234(c) provides that gain or loss shall be recognized on the exercise of an option on a Section 1256 contract (within the meaning of Section 1256(b)). Section 1234(c) also provides that, for purposes of subsections (a) and (b), a cash settlement option shall be treated as an option to buy or sell property. 85

82 Id. at Section 7208(a).


84 The term “closing transaction” means any termination of the taxpayer’s obligation under an option in property other than through the exercise or lapse of the option. Section 1234(b)(2)(A).

85 For this purposes, the term “cash settlement option” means any option which on exercise settles in (or could be settled in) cash or property other than the underlying property.
Section 1234A

Under Section 1234A, gain or loss attributable to the cancellation, lapse, expiration, or other termination of (A) a right or obligation (other than a securities futures contract, as defined in Section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, shall be treated as gain or loss from the sale of a capital asset. Similarly, gain or loss attributable to the cancellation, lapse, expiration, or other termination of a Section 1256 contract (as defined in Section 1256) that is not described in the previous sentence but that is a capital asset in the hands of the taxpayer shall be treated as gain or loss from the sale of a capital asset. This rule does not apply to the retirement of any debt instrument (whether or not through a trust or other participation agreement).

Under proposed regulations, none of the following payments would terminate or cancel a right or obligation for purposes of Section 1234A: a periodic payment described in Treas. Reg. § 1.446-3(e), a nonperiodic payment described in Treas. Reg. § 1.446-3(f), a contingent nonperiodic payment described in Prop. Reg. § 1.446-3(g)(6) to which Prop. Reg. § 1.446-3(g)(6)(ii) applies, or mark-to-market income inclusions and deductions described in Prop. Reg. § 1.446-3(i)(1). Accordingly, under the proposed regulations, Section 1234A would not apply to any of these items, including any final scheduled payment. However, under those proposed regulations, any gain or loss arising from the settlement of obligations under a bullet swap (as defined in such proposed regulations) or forward contract (including a payment pursuant to the terms of the obligations) is treated as gain or loss from a termination of the bullet swap or forward contract, and therefore would be subject to Section 1234A.

Section 1234B

Under Section 1234B(a), gain or loss attributable to the sale, exchange, or termination of a securities futures contract is considered gain or loss from the sale or exchange of property which has the same character as the property to which the contract relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by the taxpayer). Section 1234B(a), however, does not apply to (1) a contract which constitutes property described in paragraph (1) or (7) of Section 1221(a), and any income derived in connection with a contract which, without regard to that section, is treated as other than gain from the sale or exchange of a capital asset. Moreover, except as provided in the regulations under Section 1092(b) or Section 1234B, or in Section 1233, if gain or loss on the sale, exchange, or termination of a securities futures contract to sell property is considered as gain or loss from the sale or exchange of a capital asset, such gain or loss shall be treated as short-term capital gain or loss. For purposes of Section 1234B, the term “securities futures contract” generally means any security future (as defined in section 3(a)(55)(A) of the Securities Exchange Act of 1934, as in effect on December 21, 2000). For purposes of the Code, a securities futures contract is not treated as a commodity futures contract.

Reasons for Change

Problems with current Sections 1234, 1234A and 1234B

Under the common law extinguishment doctrine, the termination of a contract by agreement of the parties was generally not treated as a sale or exchange of the contract, because

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86 Section 1234A(1).

87 Section 1234A(2).
the contract ceased to exist following the termination. Accordingly, any economic gain or loss from such termination could not be considered gain or loss from the sale or exchange of a capital asset and was therefore ordinary in character. This gave the taxpayer electivity of character with respect to such contracts (assuming they were capital assets). That is, if the taxpayer had an unrealized economic gain on the contract, he could sell it and the gain would be capital, while if the taxpayer had an unrealized economic loss, he could pay the counterparty to release him from his obligations under the contract, and the resultant loss would be ordinary. Section 1234A is intended generally to reduce this electivity by treating a negotiated termination of certain derivatives as a sale or exchange of that derivative (the “deemed sale” rule). Section 1234(a), in the case of an option, and Section 1234B, in the case of a securities futures contract, are also intended to reduce the electivity with respect to the derivative contracts to which they apply.


First, under current law, the deemed sale rule applies only where the right or obligation that is terminated relates to property. There are many derivatives where a right or obligation either clearly does not relate to property (e.g., a weather derivative) or arguably does not relate to property (e.g., a fixed-for-floating interest rate swap), and Section 1234A therefore does not appear to apply to such derivatives (unless the derivative could be viewed as a right or obligation with respect to itself, which requires a convoluted reading of the statute). Under current law, however, gain on the sale or exchange of such a derivative generally would be characterized as capital gain. Moreover, under the conventional tax definition of an “option,” Section 1234 would not apply either in this situation. Thus, if a right or obligation does not relate to property, a taxpayer could cause gain to be capital by selling the derivative and could cause loss to be ordinary by terminating the derivative by negotiation with the counterparty. Such electivity is inconsistent with the overarching purpose of Section 1234A.

Second, under current law, the deemed sale rule under Section 1234A generally does not apply to a closing transaction in which the asset underlying the derivative would produce ordinary gain or loss if sold or exchanged. Therefore, in the case of a derivative that is a capital asset, but that relates to property that would be ordinary property in the hands of the taxpayer (e.g., a "store on the board" transaction), a taxpayer with a gain on the derivative can sell the derivative and recognize capital gain, while a taxpayer with a loss on the derivative can terminate it and receive

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89 For example, if an interest rate swap reflects LIBOR, which is an average of interest rates charged in the interbank market, it could be argued that the swap relates to the interbank loans from which LIBOR derives.

90 But cf. Treas. Reg. Sec. 1.1092(d)-1(c)(2) (treating, for straddle purposes, the rights and obligations of a party to a notional principal contract as rights and obligations with respect to personal property (presumably including in the case of an interest rate swap).

91 Old Harbor Native Corp. v. Commissioner, 104 TC 191 (1995) (option requires unconditional offer to do or not do a certain act, plus an agreement to leave the offer open for a defined period of time). An option on a weather derivative index, which must of necessity be cash-settled, arguably does not represent an offer to do or not do anything (e.g., to delivery or purchase property) other than to pay money.

92 On the other hand, Section 1234(a) and Section 1234B apply by their terms where the underlying property is ordinary.
ordinary loss treatment. Alternatively, a taxpayer with a loss on the derivative can take delivery of the underlying property, which could be sold at an ordinary loss.

Third, Section 1234A is unclear as to whether a final payment made under a derivative pursuant to its terms constitutes a transaction described in Section 1234A. This creates electivity on the part of taxpayers, because a taxpayer who anticipates a gain upon the receipt of such payment could negotiate an early termination of the derivative and receive capital gain on such termination, while a taxpayer who anticipates a loss upon the making of such payment could simply make the payment according to the terms of the instrument and take the position that the resulting loss was ordinary. Proposed regulations reflect this ambiguity, indicating that a final nonperiodic contingent payment on a notional principal contract over an equity index is outside the scope of Section 1234A, but the final (and only) payment on a cash-settled forward contract over that same index is within the scope of Section 1234A.

Fourth, Section 1234A has the potential to create inconsistencies in the context of positions that represent liabilities in the taxpayer’s hands. For example, a taxpayer may have entered into a “long” equity swap where the underlying stock has fallen in value since the swap’s inception and thus the swap has a negative value to the taxpayer. Assuming the underlying stock would be a capital asset in the hands of the taxpayer, Section 1234A would cause a termination of that swap to be capital, while assignment of the swap to a third party (which presumably would require a payment by the taxpayer to the third party as incentive to assume the swap) would not clearly give rise to capital treatment under Section 1221 because it is not literally a sale or exchange of property.

Fifth, there is overlap and inconsistency among the three Code sections. An option could be described in both Section 1234(a) and Section 1234A. While the three Code sections are very similar in their operation, they differ in important ways. Sections 1234(a) and 1234B apply to derivatives on ordinary or capital property, while Section 1234A only applies to derivatives on property that is (or would be) capital in the taxpayer’s hands. Section 1234(b) has a flat rule treating gain or loss on a written option as capital, albeit only for options on stocks, securities, commodities and commodity futures and not for dealers in such options. Section 1234A(2), addressing Section 1256 contracts, differs from Section 1234A(1), Section 1234(a) and Section 1234B in that it causes capital treatment to apply if the contract itself is (or would be) a capital asset without regard to the character of the underlying in the taxpayer’s hands. Finally, the three sections differ in the types of termination transactions to which they apply; for example, Section 1234A does not apply to a termination by sale, exchange or assignment, while Section 1234(a) applies to “closing transactions,” defined broadly. Consolidating the rules into a single Code section would result in significant simplification and consistency, and could also avoid unintended results in particular cases.

Possible approaches to modifying Sections 1234, 1234A and 1234B

In preparing this option, we considered the issues described above and various possible approaches to modifying these Code sections. In so doing, we believed that the threshold purpose of these sections is to prevent inconsistent results from arising when the taxpayer disposes of the same derivative contract in different ways.

93 Similarly, the termination of a derivative with respect to a Section 1231 asset (such as the termination of a lease on real property by either the lessor or the lessee) generally will not be subject to the deemed sale rule. In this situation, too, a taxpayer is allowed electivity in a manner that is inconsistent with the overarching purpose of Section 1234A.
On this basis, one option we considered, but ultimately rejected, was a simple rule that would center on the character of the derivative, rather than the underlying property, in the hands of the taxpayer. Like Section 1234A(2), such a rule could state simply that gain or loss with respect to any disposition of a derivative (including a termination by the terms of the contract, and including by assignment of the contract) that is (or would be) a capital asset in the hands of the taxpayer would be capital gain or loss. In addition to ensuring that gain or loss from all types of dispositions would be treated similarly, and thereby reducing electivity, this approach has the merit of applying equally to derivatives that do not clearly relate to any underlying property.

However, we viewed this approach as not entirely satisfactory, in that it would provide electivity to a taxpayer for whom the derivative and the underlying property are of different character, such as a taxpayer that is a dealer in the underlying property but not derivatives on that property. Such a taxpayer with an economic gain could sell the derivative to trigger capital gain, while a taxpayer with an economic loss could accept physical delivery of the underlying property pursuant to the derivative and then sell it to generate ordinary loss. While this electivity could be eliminated by treating the making or taking of delivery under a derivative contract as a mark-to-market event in at least some circumstances, doing so would have raised administrative issues, increased complexity, and represented a substantial change from current law.

Moreover, while ensuring consistency across settlement modes is a fundamental purpose of these sections, they appear, at least in the case of Sections 1234(a) and 1234B, to have a broader purpose in that by referencing the character of the underlying property they promote a general consistency of character between property and derivatives to which that property relates (a “look-through” or “transparency” rule).

On reflection, we favor retaining the “look-through” approach that is found in Sections 1234(a) and 1234B and applying it equally to those derivatives that are presently addressed only by Section 1234A. While not always true under current law, it seems to us that consistency of character between derivatives and their underlying property is desirable as a general matter. It seems logical to us, for example, that a dealer in a particular type of property should generally have ordinary treatment with respect to contracts in that property entered into in connection with its dealing business even if it is not in fact a dealer in those contracts. Put another way, if the underlying property bears such a relation to the business of the taxpayer as to generate ordinary gain or loss upon a disposition of such property, it is reasonable to treat gain or loss from the disposition of a derivative with respect to such property as ordinary as well.

We are aware that this approach would change the existing treatment of gains and losses from the disposition of certain derivatives. For derivatives other than options and securities futures contracts addressed by Section 1234(a) and 1234B, respectively, a taxpayer that is a dealer in property but not in derivatives on that property can at present only get ordinary treatment with

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94 Section 1234A(1) only performs this function for derivatives with respect to property that is capital in the taxpayer’s hands, while the other listed sections also apply to ordinary property.

95 One issue raised by both current law and the expanded “look-through” approach presented by the option we present is that a particular category of underlying property may potentially have ordinary or capital character in the taxpayer’s hands depending on the circumstances involved. For example, a dealer in securities can, by identification, treat certain securities as capital assets not held in connection with the taxpayer’s business as a securities dealer. See Section 475(b). This potential ambiguity could be addressed in regulations, perhaps through default rules or a contemporaneous taxpayer identification requirement similar to that in the hedging transaction rules.
respect to derivatives treated as hedges. Under the option we present, derivatives on that property would generally be ordinary whether or not they meet the threshold necessary to be a hedging transaction. 

We also considered the proper treatment of the disposition of positions that are obligations to the taxpayer, which can arise both when the contract is bilateral (as in the case of a swap) or unilateral (as in the case of an option written by the taxpayer). We believe that dispositions of these derivatives (including by assignment) should be treated in a manner that is consistent with that applying to dispositions of derivatives that are assets to the taxpayer at the time of their disposition. That way, a taxpayer entering into both long and short positions on similar derivatives will have gain and loss of a similar character.

Option for Consideration

Under the option, Section 1234A would be amended to provide that the character of any gain or loss attributable to the disposition or termination (by lapse, cancellation or in any other manner) of a right or obligation with respect to property shall be the same as the character of any gain that would have resulted from a sale of the underlying property. For example, if a taxpayer’s sale of property underlying a right or obligation would produce capital gain, then gain or loss attributable to the disposition or termination of that right or obligation would be capital gain or loss. Similarly, if a taxpayer’s sale of property underlying a right or obligation would produce gain described in Section 1231, then gain or loss attributable to the disposition or termination of such right or obligation would be Section 1231 gain or loss.

Section 1234A would also be amended to provide that the character of any gain or loss attributable to the disposition or termination of a right or obligation other than with respect to property (e.g., a heating degree-day swap) shall be the same as the character of any gain that would have resulted from a sale of the right or obligation.

The rules in new Section 1234A would be intended as default rules; they would not be intended to override more specific rules that apply to particular items based on the status of the taxpayer (e.g., Section 475) or on particular characteristics of a given product (e.g., Sections 988 or Section 1256). Moreover, they are not intended to override existing common law doctrines, such as the assignment of income doctrine (which, in general, relates to a transfer of the taxpayer’s right to income rather than a transfer of property), that can affect the character of income or loss.

96 We also considered the opposite situation, i.e., where the underlying property is (or would be) a capital asset in the taxpayer’s hands even though a contract on that property would (but for the recommended rule) be ordinary because, for example, the taxpayer is a dealer in such contracts. In fact, current law Sections 1234 and 1234B contain exceptions for certain contracts that are ordinary in the taxpayer’s hands, and a similar provision could be added to our proposed Section 1234A. Our belief is that this situation is likely to be infrequent, because a dealer in contracts on a type of property will often deal in the underlying property; moreover, Section 475 will require ordinary treatment in the case of securities dealers and electing commodities dealers in any event.

97 The Service may wish to consider whether an instrument should be deemed to be disposed of in the case where there the taxpayer has remaining rights or obligations with respect to the instrument but those rights or obligations are not substantial. We are not aware that this has been a significant issue under current Section 1234A.
recognized on the disposition of an interest in a financial instrument. While those doctrines are worthy of study in their own right, we believed that they were beyond the scope of this proposal.

2. **Repeal redundant portions of Section 1233**

**Present law**

Section 1233 provides rules addressing the character (and in one case the timing) of gain or loss realized from short sale transactions and put options. Section 1233(a) provides that gain or loss from the closing of a short sale is capital in character if the underlying asset is a capital asset. Section 1233(h) provides that gain is realized with respect to a short position when the underlying property becomes substantially worthless.

*Short-against-the-box holding period coordination*

Sections 1233(b) and (d) provide holding period coordination rules for short against the box situations (*i.e.*, situations where a single taxpayer is simultaneously long and short the same stock). Under Section 1233(b)(1), gain from closing a short sale is short term to the extent the taxpayer held substantially identical property with a short term holding period at any time while the short sale was outstanding. Under Section 1233(d), loss from closing a short sale is long-term to the extent the taxpayer held substantially identical long-term property at the time the short sale position was entered into. Finally, under Section 1233(b)(2), if a long position has not attained a long-term holding period at the time a corresponding short sale is entered into, the holding period of the long position is eliminated and begins to accrue again only when the short sale is closed. Where there are multiple long positions with short-term holding periods, this rule is applied on a first-in, first-out basis.

Significantly, the short-against-the-box holding period coordination rules apply by their terms only to short-against-the-box positions not governed by the straddle rules of Section 1092. Until 2004, short-against-the-box positions were excluded from the straddle rules and therefore most short-against-the-box situations were addressed by Sections 1233(b) and (d). In 2004, Congress broadened the scope of the straddle rules to include short-against-the-box positions where the stock was actively traded. Under current law, short-against-the-box positions in actively traded stock established on or after October 22, 2004, are governed by the

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98 Similarly, this proposal is not intended to override existing doctrines that may affect the treatment of life insurance contracts. Under Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, the Service ruled that the surrender of a life insurance contract by the insured gave rise to ordinary income. Without explanation, the Service stated that the conclusion was not changed by Section 1234A. The Service also ruled that the sale of the contract by the insured gave rise to ordinary income in part under the “substitute for ordinary income” doctrine.

99 Section 1233(b) and (d).

100 See Section 1233(e)(2)(A).

holding period rules of Treasury Regulations Section 1.1092(b)-2T and not by Sections 1233(b) and (d). Sections 1233(b) and (d) only apply to (i) short-against-the-box positions established prior to October 22, 2004 and (ii) short-against-the-box positions in stock that is not actively traded (if any).

The short-against-the-box holding period coordination rules of Sections 1233(b) and (d) and the straddle holding period coordination rules of Treasury Regulations Section 1.1092(b)-2T work similarly in situations where a taxpayer's entire long position is offset by a short position. In situations where there are multiple-cost lots and less than the entire long position is covered by the open short position, the two sets of rules operate differently. The short-against-the-box holding period coordination rules of Sections 1233(b) and (d) operate to ensure that the open short sale is “stacked” against the long positions in the manner that is least favorable from a holding period perspective. If a taxpayer holds lots with both long-term and short-term holding periods, loss generated from closing the open short sale position is long-term (to the extent of the long-term lots), even where the loss is generated by delivering the short-term lot to close the short sale. Similarly, gain generated from closing the short sale is short-term (to the extent of the short-term lots), even where the gain is generated by delivering the long-term lot to close the short sale.

Under the straddle rules, by contrast, a taxpayer holding more long positions than open short sale positions can identify the short position with a subset of the long positions, thereby ensuring that it receives the same long-term or short-term character as the position it is identified with even if there are other long positions with a different holding period profile. The Sections 1233(b) and (d) rules provide for the least favorable answer; the straddle rules provide for the identified answer.

**Put options under section 1233 and the “married put” rule**

Under the flush language of Section 1233(b), a purchased put option is considered a short sale (i) for purposes of classifying gain realized from the settlement of the put and (ii) for purposes of determining the holding period of the underlying long position. Thus, gain from the settlement of the put is short-term, and if the long position does not have a long-term holding period at the time the put was acquired its holding period is eliminated and does not begin to accrue while the put is held. The so-called “married put” rule of Section 1233(c) excepts from Section 1233(b) situations where the long position and the put option are acquired on the same day, provided the two positions are identified with each other and, if the put is exercised, it is exercised by delivery of the identified long position.

Significantly, Section 1233(b) has not applied to put options with respect to actively traded stock since the straddle rules were amended in 1984 to include within their scope most stock-put option positions where the stock is actively traded.102

**Hedging transactions in commodities futures**

Section 1233(g) excludes from the scope of Section 1233 hedging transactions in commodities futures. Given the hedging transaction rules of Section 1221(a)(7), this provision is basically redundant.

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102 Treas. Reg. Section 1.1092(b)-2T(d) provides a narrow exception for purposes of a now-repealed special provision previously applicable to regulated investment companies. The exception provides support for the general non-applicability of Section 1233(b) to these transactions.
Reasons for change

Section 1233 has largely been supplanted by the straddle rules as a result of their 2004 expansion. Section 1233(b) through (g) are essentially dead letter provisions, and their repeal would simplify and improve the Code.

Option for Consideration

Under this option, Section 1233(b) through (g) would be repealed.\textsuperscript{103}

3. Treat financial hedges as deemed to be identified as tax hedges

Present law

Special hedging rules have applied to certain business hedges since 1981,\textsuperscript{104} when Section 1256 was enacted. Under Section 1256, described in more detail in section II.C.1 of this submission, Section 1256 contracts that are hedging transactions are not subject to the mark-to-market and 60/40 capital gain and loss rules that would otherwise apply to them.\textsuperscript{105}

Under case law in a number of Federal courts prior to 1988, business hedges generally were treated as giving rise to ordinary, rather than capital, gain or loss. In 1988, the U.S. Supreme Court rejected this interpretation in \textit{Arkansas Best v. Commissioner}.\textsuperscript{106} In response to that decision, Treasury regulations were issued in 1994 to provide for ordinary character for business hedges and to provide timing rules requiring that gains or losses on hedging transactions be taken into account in a manner that matches the income or loss from the hedged item or items. The Tax Relief Extension Act of 1999\textsuperscript{107} amended Section 1221 to exclude a hedging transaction from the definition of a capital asset and to provide a definition of a hedging transaction.

In language that is based on the definition of a hedging transaction that was in Section 1256(e)(2), as enacted in 1981, Section 1221(b)(2)(A) defines “hedging transaction” as “any transaction entered into by the taxpayer in the normal course of the taxpayer’s trade or business primarily (i) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer, (ii) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or (iii) to manage such other risks as the Secretary may prescribe in regulations.”

\textsuperscript{103} Certain definitional or operational provisions in Section 1233(e) would be preserved to the extent needed for application of the remaining provisions of Section 1233.

\textsuperscript{104} Other tax provisions recognize the special nature of hedging transactions in a variety of contexts. For example, issuers of tax-exempt bonds may take into account the results of qualified hedging transactions in determining the yield on their bonds under the arbitrage bond regulations (Treas. Reg. § 1.148-4(h)), investors and issuers may integrate certain hedges with qualified debt instruments (Treas. Reg. § 1.1275-6), and investors and issuers may integrate a non-functional currency debt instrument and one or more qualified hedging transactions (Treas. Reg. § 1.988-5(a)).

\textsuperscript{105} Section 1256(e).

\textsuperscript{106} 485 U.S. 212 (1988).

\textsuperscript{107} Pub. L. No. 106-170.
Identification requirement and consequences of failure to identify

As originally enacted in 1981, the definition of a hedging transaction in Section 1256(c) required that “before the close of the day on which such transaction was entered into . . . the taxpayer clearly identifies such transaction as being a hedging transaction.” 108 The legislative history for this provision indicated in general that “regulations should allow taxpayers to minimize bookkeeping identification requirements in as many cases as practical,” particularly where opportunities for manipulation are minimal.109

The regulations issued under Section 1221 also contain a requirement that a hedging transaction be identified as such by the close of the day on which the taxpayer enters into the transaction, reflecting similar language in Section 1221(a)(7). An early preamble describes the objectives of the identification requirement as aiding the Service in administering the law and preventing manipulation, “such as recharacterization of transactions in view of later developments.”110 Under the Section 1221 regulations, “[t]he identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this requirement unless the taxpayer’s books and records indicate that the identification is also being made for tax purposes.”111

Under the Section 1221 regulations, if a taxpayer fails to properly identify a transaction for which it has no reasonable basis to treat as other than a hedging transaction, the Service can treat gain from the transaction as ordinary. Conversely, loss from a transaction that is a hedging transaction but is not so identified is treated as capital unless the failure to identify was due to “inadvertent error” and certain other conditions are met.112

Hedge timing

Regulations under Section 446 (the “hedge timing rule”) govern the timing of gain or loss resulting from a hedging transaction.113 Under this rule, the timing of recognition of gain or loss on a hedging transaction must generally match the timing of gain or loss on the hedged item.114 The hedge timing rule applies to any transaction that is a hedging transaction whether or not it has been identified as such for purposes of Section 1221.115 Although these hedge timing regulations

108 Section 1256(e)(2)(C).


110 T.D. 8493, 1993-2 C.B. 255. This concern was particularly evident in the context of stock investments, where uncertainty as to treatment led to taxpayers’ treating losses as ordinary and gains as capital. Under the Section 1221 regulations, stock holdings may not be hedging transactions, so their treatment is now clear. Treas. Reg. § 1.221-2(d)(5)(i).


112 Treas. Reg. § 1.1221-2(g)(2).

113 Treas. Reg. § 1.446-4.

114 Treas. Reg. § 1.446-4(d).

also contain additional recordkeeping and identification requirements, compliance with them does not appear to be a prerequisite for application of the hedge timing rule.\\(^\text{116}\)\\

**Special considerations for Section 1256 contracts**\\

In connection with the 1999 amendments to Section 1221 to codify the separate treatment of business hedges, the separate definition of a hedging transaction in Section 1256(e)(2) was replaced by a cross-reference to the definition in Section 1221(b)(2)(A). However, 1256(e)(2) retains its own same-day identification requirement, without any provision for an inadvertent error exception.\\(^\text{117}\) In a situation where the inadvertent error exception applies for purposes of the application of Section 1221, the character of gain or loss on the Section 1256 contract will be ordinary, but it is not clear whether the hedge timing regulation applies to override the mark-to-market timing rule of Section 1256. The hedge timing rule provides that it overrides any inconsistent timing rule in another regulation,\\(^\text{118}\) but the Section 1256 mark-to-market timing rule is statutory. The result of a failure to override the statutory rule would be mark-to-market timing and ordinary character.

**Financial accounting for hedging transactions**\\

In parallel with the tax rules applicable to hedging transactions, similar financial accounting rules for hedges have developed over time. In June 1998, the Financial Accounting Standards Board (FASB) issued Statement No. 133 (Accounting for Derivative Instruments and Hedging Activities), which has since been amended on several occasions. For financial accounting purposes, “derivatives” (which can include certain elements embedded in a “host” contract\\(^\text{119}\)) are assets or liabilities for financial accounting purposes and, if not designated as a hedging instrument or not meeting the requirements for hedge accounting, are generally required to be held at fair value.\\(^\text{120}\) The standards for treating a hedge as such for financial accounting purposes are generally higher than those for hedging transaction treatment under the tax rules: a financial accounting hedge must be “highly effective” in offsetting the hedged item, as demonstrated by prospective and ongoing quantitative analyses.\\(^\text{121}\) In contrast, a hedging transaction for tax purposes must merely “manage” risk.\\(^\text{122}\)

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\\(^\text{116}\) A willful failure to keep required records may result in penalties under Section 7203.

\\(^\text{117}\) Treas. Reg. § 1.1256(e)-1(c) provides that an identification made for purposes of Section 1221 will also serve as an identification for purposes of Section 1256. If a taxpayer shows that it inadvertently identified a transaction as a hedging transaction as permitted by the Section 1221 regulations, the transaction will also be treated as not having been identified for purposes of Section 1256. Finally, a Section 1221 identification that does not satisfy all of the detailed identification requirements of the Section 1221 regulations will nevertheless be treated as an identification under Section 1256.

\\(^\text{118}\) Treas. Reg. § 1.446-4(a).


\\(^\text{120}\) FASB ASC No. 815-10-10-1(b).

For financial accounting purposes, two primary types of hedging transactions are recognized: cash flow and fair value hedges. Cash flow hedges are transactions structured to reduce the variability of cash flows due to changes in rates or prices (e.g., a floating-to-fixed interest rate swap), and the portion of the changes in their fair value that is effective as a hedge is allocated to other comprehensive income (“OCI”) and then reclassified into earnings during the period in which the variability of the hedged item impacts earnings. Fair value hedges are transactions structured to reduce exposure to changes in the fair value of an asset or a liability (or a portion thereof) that is attributable to a particular risk (e.g., a fixed-to-floating interest rate swap), and fluctuations in their fair value are recognized currently into earnings along with similar fluctuations in the hedged item. Like the tax rules applicable to hedging transactions, the hedge accounting rules have the effect of aligning the income recognition of a derivative used as a hedging transaction with that of the hedged item.

While the financial accounting rules applicable to each type of hedge vary, both require companies to formally document the hedging transaction at its inception. This documentation must include, inter-alia, formal documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge, as well as identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument’s effectiveness will be assessed. These documentation requirements parallel the detailed identification requirements in the Section 1221 regulations and, like those requirements, are intended to prevent companies from using hindsight in establishing treatment of a transaction.

Reasons for change

The rules for financial accounting hedges and tax hedges both serve to match the treatment of the hedge with the hedged item whose risk it manages, and both require contemporaneous identification in order to avoid determinations made in hindsight. Because of the more stringent requirements for financial accounting hedges, most financial accounting hedges of a risk enumerated in Section 1221(b)(2)(A) will also meet the risk management standard for a tax “hedging transaction.” As a result, transactions identified by a taxpayer as financial accounting hedges that are eligible for hedging transaction treatment should also in most instances be treated as tax hedges: their timing should match the hedged item and their character should be ordinary.

The rule that hedging transactions must be separately identified for tax purposes and that an identification for financial accounting purposes is insufficient has created tax uncertainty in numerous cases in which the facts clearly establish that the primary purpose of a transaction is to hedge one of the risks enumerated in Section 1221(b)(2)(A). Responsibility for hedging transactions is often lodged with accounting personnel who do not immediately advise their tax department colleagues that a hedging transaction has occurred. That a separate identification may be required for tax purposes is not intuitive.

(continued…)

122 Section 1221(b)(2)(A).

123 FASB ASC No. 815-20-25-3.

124 ASC 815 recognizes that without concurrent designation, “an entity could retroactively identify a hedged item, a hedged transaction, or a method of measuring effectiveness to achieve a desired accounting result.” Id.
Relatively little formal guidance exists with respect to the inadvertent error exception. While in practice the facts will often support the availability of the inadvertent error exception, it should be unnecessary to undertake the required analysis in a case in which the taxpayer’s hedging purpose for entering into the transaction is clearly established by its accounting treatment.

During the period of initial development of the tax hedging rules, the financial accounting standards for hedging transactions were also in a developmental stage. Currently, those standards are relatively stable, and the financial accounting identification requirements for hedging transaction are clear and detailed, leaving little uncertainty about whether a transaction has been identified as a hedge for financial accounting purposes. As a result, these identifications would serve the same purposes the tax identification requirement is intended to serve: aiding the Service in administering Section 1221, and preventing manipulation by the taxpayer.

Because Section 1256 contains no inadvertent error exception, there is significant uncertainty about the proper timing treatment of Section 1256 contracts, such as foreign currency contracts, that serve as hedging transactions for tax purposes but were not identified as tax hedges. If these contracts are required to be marked to market because the hedge timing rule does not override the timing rules of Section 1256, the timing of recognition of gain and loss on these contracts will not match the timing of the hedged item, resulting in a distortion of income.

Option for Consideration

A transaction would be treated as meeting the hedge identification requirement under Section 1221 if the transaction qualifies as a hedging transaction for tax purposes, is identified as a hedging transaction for financial accounting purposes, including the requirement that the hedge be identified at inception. Under the option, the taxpayer’s treatment as a hedge for financial accounting purposes would also satisfy the separate identification and recordkeeping requirements under the hedge timing regulations.

The option addresses only the separate identification requirement. A transaction identified as a hedging transaction for financial accounting purposes would be treated as a hedging transaction for tax purposes only if it was a hedging transaction as defined in Section 1221(b)(2)(A).

For identified financial accounting hedges, a taxpayer would be permitted to make a specific identification out of hedging treatment for tax purposes by the end of the day of the transaction, in which case the transaction would not be treated as a hedge for tax purposes unless the taxpayer has no reasonable basis for treating the transaction as other than a hedging transaction for tax purposes. A failure to identify out of tax hedge treatment in this manner would not preclude the taxpayer from taking the position that the transaction is not a hedging transaction for purposes of Section 1221(b)(2)(A) if it can support such a position, but the taxpayer would no longer have the benefit of the presumption that the transaction should not be treated as a tax hedge under Section 1221.

Because of a statutory cross-reference, adoption of the proposal could affect the application of a special hedging rule applicable to REITs. See Section 856(c)(5)(G)(i). Consideration should be given to whether the modification of the identification requirements should also apply for purposes of that rule and other special hedging rules.

The purpose of the proposal is to relieve taxpayers from the burden of showing that the failure to make a separate hedging tax identification was due to inadvertent error in cases in which the transaction is identified as a hedge for accounting purposes and the transaction clearly (…continued)
A taxpayer would not be precluded from making a separate tax identification, whether or not the transaction is identified as a hedging transaction for financial accounting purposes.

The separate Section 1256 identification requirement would be eliminated so that a transaction that qualifies as a hedging transaction under Section 1221(b)(2)(A) would also qualify as a hedging transaction under Section 1256(e)(2).

4. Repeal of Section 1236

Present law:

Section 1236 provides rules addressing the character of items of gain and loss with respect to securities in the hands of a securities dealer. Under Section 1236(a), capital gain treatment is limited to securities that (i) at the time of their acquisition, are “clearly identified in the dealer’s records” as held for investment and (ii) at no time were held for sale to customers (i.e., included in securities inventory). Under Section 1236(b), ordinary loss treatment is limited to (i) securities afforded ordinary treatment under Section 582(c) (generally debt securities held by banks and other financial institutions), and (ii) securities that have never been identified as held for investment. Regulations define a “securities dealer” for purposes of Section 1236 as a “merchant of securities” “regularly engaged in the purchase of securities and their resale to customers.”

Reasons for change:

In 1993, Congress enacted Section 475 to provide comprehensive timing and character rules for securities in the hands of securities dealers. The Section 475 definitions of “securities” and “securities dealers” are broader than those of Section 1236. All Section 1236 securities are Section 475 securities, but not vice versa, and all Section 1236 dealers are Section 475 dealers, but not vice versa.

Section 475 prevents character manipulation by dealers (the same policy concern of Section 1236) by a similar mechanic. If a security is held for sale to customers (i.e., a security described in Section 475(a)(1)), gains and losses from it are ordinary under 1221(a)(1). If a security is held by a dealer but is not technically inventory (i.e., a security described in Section 475(a)(2)), the dealer must identify the security in or out of its mark-to-market book under Section 475(b)(1). If the security is included in the mark-to-market book, gain or loss in respect of it generally would have ordinary character under Section 475(d)(3). If the security is excluded from the mark-to-market book, gain or loss with respect to it would have character determined without regard to Section 475—usually capital.

Section 475's rules are adequate to prevent character whipsaws. There is no need to apply the largely overlapping rules of Section 1236 in situations where both technically apply. Under current law, a failure to synchronize Section 475 and Section 1236 identification statements can result in inappropriate character whipsaws. Accordingly, Section 1236 represents a trap for (continued…)

falls within the definition of a hedging transaction for tax purposes. If there is concern that taxpayers may seek to game the system by claiming a transaction is not a hedging transaction when it results in gain rather than loss, which should be possible only when the qualification of the transaction as a tax hedging transaction under Section 1221(b)(2)(A) is not clear, taxpayers could be required to meet a higher standard in such cases.

the unwary and a compliance burden for taxpayers without a corresponding tax policy benefit. Repealing it would simplify and improve the Code.

Options for Consideration

Under the option, Section 1236 would be repealed.

C. Mark-to-Market of Financial Transactions

1. Rationalize Section 1256

Present Law

Gains and losses from the taxable sale, exchange, disposition or deemed disposition of property generally are capital, except for a dealer in the property, in which case they are ordinary. Capital gain or loss generally is long-term if the property was held for more than one year, subject to various limitations, and otherwise is short-term. Capital losses generally can be carried back three years and carried forward for five years in the case of a corporation, while other taxpayers may not carry back capital losses but may carry them forward indefinitely.

Special rules apply to gains and losses with respect to “Section 1256 contracts.” Any gain or loss with respect to a Section 1256 contract, including gain or loss on the termination or transfer of a Section 1256 contract, is subject to a mark-to-market rule and generally is treated as long-term capital gain or loss, to the extent of 60 percent of the gain or loss, and short-term capital gain or loss, to the extent of the remaining 40 percent of the gain or loss (the “60/40 rule”), regardless of the taxpayer’s actual holding period for the contract. A taxpayer other than a corporation may elect to carry back its net Section 1256 contracts loss for three taxable years to offset Section 1256 gains in those years. In the case of an options dealer or commodities dealer, net capital gain from dealing in or trading Section 1256 contracts is treated as included in net earnings from self-employment subject to tax under Section 1401.

When Section 1256 was enacted in Section 1981, its mark-to-market rule was based on constructive receipt principles, because taxpayers that entered into the only contracts to which Section 1256 applied (futures contracts traded on U.S. commodities exchanges) are subject to rules under which daily “variation margin” is paid or received by each party to the contract, in cash, in an amount equal to the change in value of the contract from the prior business day. Because any cash received generally may be withdrawn and used by the taxpayer, the concerns about valuation and liquidity of daily gains and losses that often are cited as reasons for the use of a realization method of accounting were not considered a bar to imposing mark-to-market accounting.

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128 See Section 1221(a)(1) (excluding stock in trade, inventory and other property held primarily for sale to customers in the ordinary course of business from the definition of “capital asset”).

129 Section 1222.

130 Section 1212(a)(1) (corporations) & (b)(1) (other taxpayers).

131 Section 1212(c).

132 Section 1402(i).
accounting on these contracts. However, Section 1256 was soon expanded to apply to other contracts that are not subject to daily variation margin requirements for both parties to the contract.

The 60/40 rule appears to have been intended to provide relief to taxpayers previously not subject to mark-to-market tax accounting rules for futures contracts.\textsuperscript{133} The net loss carryback rules and self-employment tax rules create a special regime for Section 1256 traders that bears some resemblance to the rules that ordinarily apply to taxpayers engaged in an operating business.

Section 1256 generally applies to any (i) regulated futures contract, (ii) foreign currency contract, or (iii) nonequity option, as those terms are defined by Section 1256. Regulated futures contracts and nonequity options are traded on commodities exchanges while foreign currency contracts are traded in the over-the-counter market. In addition, in the case of dealers therein, these rules also apply to any (4) dealer equity option and (5) dealer securities futures contract.\textsuperscript{134} Taxpayers may elect to have Section 1256 not apply to a Section 1256 contract that is part of a “mixed straddle” or a “hedging transaction.”\textsuperscript{135} In addition, Section 1256 does not apply to any interest rate swap, credit default swap or certain other specified swaps and similar agreements.\textsuperscript{136}

Special rules also apply under Section 475 to dealers in securities, dealers in commodities, and traders in securities or commodities. Dealers in securities, including derivative financial instruments on equities, debt instruments or currencies, are required to mark their securities positions to market and to treat any gain or loss thereon as ordinary, unless the position is held for investment or, with respect to the character of gain or loss, the position is not held in connection with the taxpayer’s activities as a dealer in securities.\textsuperscript{137} For this purpose, a Section 1256 contract is not treated as a “security” unless it hedges a security.\textsuperscript{138} Dealers in commodities and traders in securities or commodities may elect similar mark-to-market and ordinary treatment.\textsuperscript{139} Section 1256 contracts are included in the term “commodities” for this purpose.\textsuperscript{140} Consequently, under Section 475 dealers and traders in commodities that elect mark-to-market treatment for their commodities positions treat Section 1256 contracts on commodities in the same way as other commodities derivatives, i.e., as giving rise to ordinary gain or loss, while dealers and electing traders in securities treat Section 1256 contracts on securities as giving rise to ordinary gain or loss only if the contract hedges a security.

\textsuperscript{133} We note, however, that relief for the traders that had been using straddles to zero out their income was provided by an out-of-Code installment payment mechanism in Section 509.

\textsuperscript{134} Section 1256(b)(1). For this purpose, an options dealer is defined as a market maker or specialist in listed options. Section 1256(g)(8). In the case of securities futures contracts, members of an exchange that regularly provide two-way (bid and ask) quotations for securities futures contracts qualify as dealers. See Section 1256(g)(9)(B); Rev. Rul. 2004-95, 2004-2 C.B. 493.

\textsuperscript{135} Section 1256(d) (mixed straddles) & (e) (hedging transactions).

\textsuperscript{136} Section 1256(b)(2).

\textsuperscript{137} Section 475(c)(2).

\textsuperscript{138} Section 1256(c)(2)(F) & flush language.

\textsuperscript{139} Sections 475(e) (dealers in commodities), (f)(1) (traders in securities) & (f)(2) (traders in commodities).

\textsuperscript{140} Section 475(e)(2)(C).
Reasons for change

In the case of dealers and market makers in Section 1256 contracts, the treatment of gain or loss as capital gain or loss and the application of the 60/40 rules are inconsistent with the Code’s general rules. Gain or loss from property held in connection with a dealer’s business ordinarily is treated as ordinary, in accordance with the long-standing rule of the Code that ordinary rather than capital treatment is appropriate for taxpayers engaged in the normal course of their business activities. While some may argue that the activities of dealers and market makers in futures and other Section 1256 contracts are closer to those of traders than dealers in stocks, bonds and over-the-counter derivatives, it has long been the law that a taxpayer may be a dealer even if it buys and sells solely on an exchange with other professional market participants. Moreover, the commodities exchanges impose requirements on market makers that do not apply to other traders on those exchanges, and accord them special privileges like lower fees in recognition of their market-maker status. Accordingly, we believe for example that market makers in exchange-traded equity options should be not be treated differently from dealers in over-the-counter equity options.

In the case of other taxpayers, capital gain or loss treatment generally is appropriate. We believe, however, that consideration should be given to the scope of mark-to-market treatment for contracts that are traded on exchanges and, pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), on swap execution facilities, or that are cleared through clearinghouses, in order to develop a more coherent framework for determining when a contract should be marked to market for tax purposes. In addition, we believe that 60/40 treatment should be repealed, as the transition considerations that apparently animated its adoption should have dissipated since it is now 30 years after Section 1256 was enacted.

Under current law, there are many discontinuities in the scope of mandatory mark-to-market rules for non-dealers that enter into a derivative financial instrument. For example, broad-based equity index options traded on an exchange are subject to Section 1256, but single stock or narrow-based equity options traded on an exchange are not. Contracts traded on a regulated securities or commodities exchange are automatically treated as Section 1256 contracts if they otherwise fall within the Section 1256 contract definition, while similar contracts traded on other exchanges are treated as Section 1256 contracts only at the Service’s discretion.

141 See Helvering v. Fried, 299 U.S. 175 (1936) (specialist on New York Stock Exchange, all of whose customers were other members of the exchange, was a dealer in stock and entitled therefore to use the inventory method of accounting for its stock positions); Rev. Rul. 60-321, 1960-2 C.B. 166 (specialist on stock exchange is a dealer and may use LIFO inventory method to value his securities).


143 Similarly, there is no policy reason why dealers in exchange-traded equity options are subject to 60/40 capital gain or loss treatment, while traders in equity options must elect ordinary treatment under Section 475(f) to benefit from marking those positions to market, for example in order to eliminate the need to defer losses under the straddle rules of Section 1092.

These discontinuities arise in part because of the split regulatory framework for securities and commodities. More generally, however, they are the result of the development of many new types of exchange-traded contracts and new types of markets on which financial instruments are traded since 1981. For example, the commodities exchanges have continued to develop new contracts for trading on their exchanges, some of which are now largely indistinguishable from contracts not traded on exchanges.\(^\text{145}\) Another example is that there are now markets for trading derivative financial instruments, including regulated markets, that do not fall within the definition of a “qualified board or exchange” for Section 1256 purposes.\(^\text{146}\) The changes to derivatives markets now under way as a result of Dodd-Frank will create further discontinuities in tax treatment between similar instruments, as a result of the requirement to clear certain categories of swaps. It is difficult to draw rational lines between over-the-counter interest rate swaps, cleared interest rate swaps, futures with interest rate swap payment terms, and futures contracts whose settlement payment is based on the terms of an interest rate swap, all of which exist today in the market.

The lack of coherence in the tax rules for Section 1256 contracts also is the result of changes in the law. As noted above, the enactment of Section 1256’s mark-to-market rules was based on constructive receipt principles, but Section 1256 now applies to financial instruments that are not subject to two-way variation margin requirements (e.g., certain equity options), and to financial instruments that are not subject to any mandatory margin requirement (e.g., foreign currency contracts). Conversely, Section 1256 does not apply to interest rate and credit default swaps that are subject to two-way variation margin requirements, although those requirements differ in some important respects from variation margin payable on futures contracts.\(^\text{147}\) While each of these rules has a rationale, as a whole the rules are not coherent and should be rethought.

The 60/40 rule results in a blended rate for gains and losses on Section 1256 contracts that is significantly lower than the rate for short-term capital gains and losses. We are aware of no policy reason to provide preferential treatment for these gains and losses. Lower capital gains rates are intended to encourage long-term investments in capital assets such as stock. Whatever the merits of extending preferential rates to derivative financial instruments generally, we do not believe that there is a policy basis for providing those preferential rates to taxpayers who have not made such long-term investments. Furthermore, the fact that traders choose to make elections to mark their securities and commodities to market under Section 475, at the cost of ordinary income taxation, suggests that no special rate inducements need be provided for traders on commodities exchanges.

\(^\text{145}\) For example, the OMX exchange offers a futures contract on interest rate swaps that provides for periodic fixed-versus-floating payments identical to those of over-the-counter interest rate swaps.

\(^\text{146}\) See Sesco Enterprises, LLC, 2010-2 USTC ¶ 50,733 (concluding that the Service has complete discretion to decide whether markets for trading electricity futures contracts regulated by the Federal Energy Regulatory Commission are “qualified boards or exchanges” for Section 1256 purposes and that taxpayer cannot sue to force the Service to make such a determination).

\(^\text{147}\) Under current clearinghouse rules, the variation margin system for cleared swaps is not identical to the variation margin system for other contracts. Notably, interest is paid on variation margin for cleared swaps, so that it functions more like a loan than a payment to the margin recipient.
Options for Consideration

Dealers and market makers

In order to conform the treatment of dealers and market makers in Section 1256 contracts to the treatment of dealers in other similar derivative financial instruments, an option for consideration is to amend Section 1256 so that it does not apply to dealers and market makers. A correlative change would be to amend Section 475 to require mark-to-market and ordinary treatment for dealers and market makers in such contracts, similar to the rules that apply to dealers in securities. In the case of Section 1256 contracts with respect to equities, debt instruments and currencies, the rules for dealers in securities can be modified to treat such contracts as securities. In the case of Section 1256 contracts on commodities and other risk positions, additional modifications to Section 475 would need to be made in order to mandate mark-to-market and ordinary treatment for such contracts. If these options are adopted, the special rules treating net capital gains of options market makers and commodities dealers as subject to self-employment income should be repealed or revised so that such dealers’ income is subject to self-employment tax in the same way as other self-employed taxpayers. Similarly, the special loss carryback rules for Section 1256 losses would no longer apply to these taxpayers, but the normal net operating loss rules of the Code would be applicable. Because these taxpayers are actively engaged in the day-to-day activities of their businesses, the new 3.8 percent tax imposed by Section 1411 should not apply to their income from dealing in futures and other contracts subject to mark-to-market treatment, as long as the income is derived from their activities as dealers.

Non-dealers

A threshold question is whether contracts like futures contracts traded on a commodities exchange should be subject to mark-to-market treatment. We agree with Congress’s determination in 1981 that mandatory mark-to-market for futures contracts was appropriate, in light of (i) the daily receipt or payment of cash margin that economically functions like a payment on the contract, and (ii) the ability to obtain a reliable valuation of the contract on a daily basis. Other attributes of futures contracts that support mark-to-market treatment are (iii) the fact that futures contracts provide for a single bullet payment, generally at a near-term maturity,


148 Section 475 provides for ordinary income treatment if securities are held in connection with the business of dealing in securities. Similar rules presumably would apply to these contracts.

The special rules of Section 1221(a)(6) and (b)(1)(B)(i) that provide that commodity derivative financial instruments, other than Section 1256 contracts, generally do not constitute capital assets if held by a commodities derivatives dealer, also should be amended to remove the reference to Section 1256 contracts.

149 The lack of periodic payments on a futures contract, as compared for example to an interest rate swap contract, means that mark-to-market gain or loss reflects a single payment that will be fixed only at maturity, rather than a payment that accrues over time, and thus avoids potentially difficult questions about how to take accrued time value of money amounts into account. For example, if the payor on the fixed leg of an interest rate swap were to recognize a capital loss at the end of year 1 because fixed rates exceed floating rates and the swap therefore was out-of-the-money to that taxpayer, and subsequently floating rates dropped with the result that in year 2 the taxpayer received rather than made a periodic payment on the swap, the same economic term of the swap – the obligation to pay fixed and the right to receive floating rates – would have given rise to a capital loss and ordinary income.
and (iv) the fact that taxpayers may close out a futures contract at any time and thus fix their gain or loss. Accordingly, we propose no change to Section 1256(a)(1) (mark to market) or Section 1256(a)(2) (corresponding adjustments) as they apply to futures contracts.

An option for consideration would be to cause contracts with similar terms to be subject to mandatory mark-to-market treatment. (For ease of discussion, we refer to any such contracts as “MTM contracts.”) The identification of contracts that are sufficiently similar to contracts that satisfy all of the requirements described above depends on which of those criteria are considered the most critical. For example, it may be desirable for different rules to apply to long-term contracts that provide for periodic payments, like interest rate swaps, than to short-term bullet payment contracts like futures contracts. However, a distinction of this kind raises issues similar to those considered by Congress in 1984 when it expanded the scope of Section 1256 to include options to enter into futures contracts in order to eliminate potential whipsaw or arbitrage between such options and the underlying futures contracts, because an exchange-traded option or future to enter into or make a settlement payment determined by reference to such a swap presumably would be a MTM contract. Accordingly, an alternative approach might be to treat any contract that satisfies criteria (i), (ii) and (iv), or any contract to enter into such a contract, as an MTM contract. A further question would be whether to treat only exchange-traded or cleared contracts as MTM contracts, or to apply similar rules to contracts in the over-the-counter market with similar characteristics.

Mandatory mark-to-market rules for financial instruments that are capital assets raise a number of ancillary issues, including, if the 60/40 rules are repealed, how to determine the holding period of gains and losses once the contract has been in existence for more than one year. There is no precedent for addressing this issue. Another issue to be considered is whether to continue the special loss carryback rule for net capital losses from Section 1256 contracts to alleviate the capital loss limitation rules for active traders in Section 1256 contracts. A third question is whether to modify the treatment of taxpayers that enter into Section 1256 contracts for hedging purposes.

In the case of holding period, we do not believe that it is desirable to develop a system under which the holding period of gain or loss on a MTM contract changes once the contract has been held for more than one year. First, treating only post-one-year gains or losses as long-term gains or losses does not reflect our current approach to long-term capital gain/loss treatment, which treats all gain or loss recognized after the one-year mark as eligible for favorable rates in the hands of individual taxpayers. Second, because mark-to-market treatment in part reflects the

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150 When a contract has a short term, the lag between the date on which the taxpayer recognizes gain (or loss) under a mark-to-market regime and the date on which the taxpayer’s right to that gain (or obligation to pay the loss) is permanently fixed is short. Consequently, concerns about the impermanence of mark-to-market gains and losses are mitigated. The amount of difference between the mark-to-market gain/loss and the final gain/loss is also less likely to be significant when the contract is short-term rather than long-term.

151 If a taxpayer cannot terminate a contract prior to its maturity without the consent of another party, requiring the taxpayer to pay tax on mark-to-market gain, or permitting the taxpayer to deduct mark-to-market losses, may be less appropriate. How significant the existence of a right to terminate at any time should be as a basis for subjecting a contract to mark-to-market treatment is open to debate, however, as taxpayers can sell a stock or bond position at any time, and the constructive receipt doctrine does not apply if a taxpayer must surrender a material economic benefit, like the potential for future gain, in order to obtain cash.
fact that the taxpayer could readily close out the contract and enter into a new one, applying different holding period rules to MTM contracts that are actually closed out and reentered into and MTM contracts that a taxpayer continues to hold does not seem to have a compelling policy logic, and would invite arbitrage. Third, treating pre-one-year and post-one-year gains and losses differently could give rise to short-term capital loss/long-term capital gain, or short-term capital gain/long-term capital loss, from the same contract, which could give rise to either a tax advantage or tax disadvantage to any particular taxpayer on a random basis. Any attempt to adjust for those results is likely to be complex. Finally, under current law most contracts that would be MTM contracts are short-term in any event, so developing a novel system for addressing post-one-year gain or loss would have limited effect. Accordingly, an option would be to treat all capital gain or loss from a MTM contract as short-term capital gain or loss.

If the options discussed above to repeal 60/40 treatment and treat all MTM contract capital gains and losses as short-term capital gains or losses are adopted, then the timing rules for taxpayers that speculate through the use of MTM contracts will be disfavored compared to taxpayers that use other types of financial instruments in several ways. First, because MTM contracts are marked to market, taxpayers cannot delay the recognition of their capital gains. Moreover, they may recognize capital gains in one year and capital losses in the next year from the same contract, with the potential result that they must pay tax in the first year without being able to deduct the loss in the second year. The option discussed above of retaining the special loss carryback rule for losses from Section 1256 contracts would address the second of these and consequently alleviate the effect of the first.

On the other hand, most contracts to which Section 1256 applies today are short-term contracts. A contract that is entered into and closed out in the same taxable year is properly taxed on a current basis on the resulting gains and losses. Retaining the special loss carryback rule for Section 1256 losses thus provides more relief than may be necessary to alleviate the potential whipsaw that can arise if a taxpayer holds a MTM contract over year-end. Moreover, taxpayers that are concerned about their ability to deduct losses from MTM contracts can make a Section 475 election.

On balance, we believe that the option of retaining the special loss carryback rule has merit in view of the unusually harsh results that can arise from mandatorily marking contracts that may give rise to capital losses to market. However, the option of limiting the carryback period to one year should be considered in view of the generally short-term nature of most current Section 1256 contracts.

In the case of taxpayers that use Section 1256 contracts as a hedge of another position, like a bond portfolio, existing law provides some relief, but imperfectly. Under current law, a taxpayer may elect for Section 1256 not to apply to a Section 1256 contract if the contract is part of a “mixed straddle” (Section 1256(d)) or a “hedging transaction” (Section 1256(e)). We believe that the hedging transaction rules work well, subject to the discussion of Section 1256(e) in section II.B.3 of this submission. They allow taxpayers that use MTM contracts to which those rules apply to avoid the acceleration of MTM gains, the capital loss limitation rules, and deferral of MTM losses under the straddle rules under circumstances where MTM creates a mismatch between the hedged item and the hedge. However, those rules apply only to hedges of ordinary assets or liabilities. Taxpayers that hedge capital assets, for example by hedging a bond portfolio held for investment, may suffer from similar concerns but lack a comparable matching rule to alleviate them. An option to better deal with this issue would be to replace the mixed straddle rule, which is difficult to apply because of uncertainty about when it is available and the restrictive nature of its identification rules, with a rule that allows taxpayers to elect to treat MTM contracts as not subject to Section 1256 if the contracts and the assets they hedge would be within the scope of the hedging transaction election if the assets were ordinary assets. In particular, this rule would incorporate upfront identification requirements similar to those currently required for hedging transactions, in order to prevent taxpayers from making determinations with the benefits of hindsight.
2. Broaden the scope of Section 475(f)

Present law

Under Section 475(f), a taxpayer that is a “trader” in securities (or commodities) can elect to recognize income and loss on its securities or commodities activities on a mark-to-market basis. To be eligible for the election the taxpayer must be engaged in a trade or business as a “trader” (a “trader business”) in the year the election is made.¹⁵²

The election applies to all securities (or commodities) that have some “connection” with the trader business. A taxpayer may exclude from its mark-to-market election (by a date-of-acquisition identification statement) only those securities (or commodities) “having no connection” to the activities of the taxpayer as a trader.¹⁵³

If the election is properly made and the securities (or commodities) included in the election are properly identified, the securities are accounted for on a mark-to-market basis for tax purposes.¹⁵⁴ The character of all gain or loss is ordinary.¹⁵⁵

Reasons for change¹⁵⁶

Section 475(f) was enacted because Congress believed that, with respect to market-traded property, a mark-to-market tax accounting method represented a clear reflection of income and was not easily manipulated.¹⁵⁷ From the perspective of an electing trader, the mark-to-market method was viewed as desirable, notwithstanding that all income is taxed at ordinary rates and in some instances accelerated, because the trader has relative simplicity and certainty of treatment, avoids having unusable capital losses, and generally avoids the sometimes harsh consequences of the straddle and wash sale rules.¹⁵⁸

Although Section 475 does not define “trader,” the term has been defined in cases addressing whether a non-corporate taxpayer may take above-the-line deductions under Section 162 for expenses, such as brokerage fees, that relate to the taxpayer’s transactions in securities.

¹⁵² Section 475(f)(1)(A) & (f)(2).

¹⁵³ Section 475(f)(1)(B).

¹⁵⁴ Section 475(f)(1)(A).

¹⁵⁵ Section 475(f)(1)(D).

¹⁵⁶ For ease of reading and because much of the relevant authority applies to securities transactions, this discussion will refer generally to securities and not to commodities. However, as noted below, this proposal is intended to apply equally to commodities as defined by Section 475.

¹⁵⁷ See, e.g., House Ways and Means Committee Report, Description of Revenue Reconciliation Bill, reprinted at 97 T.N.T. 118-23 (June 13, 1997) (“Mark-to-market accounting generally provides a clear reflection of income with respect to assets that are traded in established markets. For market-valued assets, mark-to-market accounting imposes few burdens and offers few opportunities for manipulation.”).

¹⁵⁸ See, e.g., Lee A. Sheppard, News Analysis: Making Traders Mark to Market, 97 TNT 154-5 (Aug. 11, 1997) (“Ordinary treatment recommends itself to traders who would rather not be subject to capital loss limitations, as well as the loss deferral rules of sections 1091 and 1092.”).
Perhaps motivated by concerns about permitting individual taxpayers who dabble in securities trading to deduct things like home offices and newspaper subscriptions, courts addressing the issue have adopted stringent requirements – in particular, a very high volume of annual trades – for “trader” classification.\textsuperscript{159} As a result, many investment funds and other taxpayers whose annual securities trading volume is quite substantial, including corporate entities not concerned about the Section 162 deduction issue that fueled the “trader” cases, may nonetheless fall below the standard required for trader status.

Moreover, because of the fact-specific nature of the analysis, the determinations as to (i) whether and when a taxpayer’s activities as a whole rise to the level of a trader business and (ii) whether and when a particular security position bears a sufficient connection with a trader business are often difficult to make with certainty and can vary from year to year. For a taxpayer that may be but is not clearly a trader under the relevant case law – or that holds securities that are not clearly connected to its trading business – the stakes of judgments can be high because the mark-to-market method and the realization method can provide such different results.\textsuperscript{160}

Although they engage in a lower annual volume of securities transactions, these “near traders” often have the preference for certainty and simplicity in tax treatment, and the same concerns about the straddle and wash sale rules and capital losses, as do taxpayers that are undoubtedly Section 475 traders.

From the government’s perspective, permitting these taxpayers to mark their securities holdings to market, where those securities are publicly traded or otherwise subject to a robust method of establishing valuation, should provide a clear reflection of income in the same way the method does for traders, assuming the election must be made in advance (as is currently true for traders) and that any concerns about selectivity among securities positions can be addressed. Under these circumstances, the government should not be disadvantaged because it cannot generally be known in advance whether mark-to-market treatment will result in more or less tax than the realization method.\textsuperscript{161} In fact, many commentators have argued that mark-to-market accounting is, as a policy matter, the most appropriate treatment for securities and derivatives whose values are easily measureable.\textsuperscript{162}

\textsuperscript{159} See, e.g., \textit{van der Lee v. Comm’r}, T.C. Memo. 2011-234, Sept. 29, 2011 (taxpayer not a trader despite 159 trades during the year); \textit{Moller v. United States}, 721 F.2d 810 (Fed. Cir. 1983) (holding that taxpayers who engaged in 100-125 trades a year and devoted 40-42 hours per week to trading did not have a trade or business).

\textsuperscript{160} In proposed regulations, the Service has asserted that it can, upon examination, move securities out of an electing trader's mark-to-market book if it determines the securities have “no connection with” the trading activities. \textit{See Prop. Treas. Reg. § 1.475(f)-2(a)(5)}. In theory, the Service could use this authority to flip the character of losing investments to capital (and timing to realization) even though, had the taxpayer made a profit on the investment, the taxpayer would have been required to account for it as ordinary income (with mark-to-market timing).

\textsuperscript{161} As under current Section 475(f), there may be circumstances, for example in connection with a wasting asset, in which it would be appropriate for Treasury to provide an exception to mark-to-market treatment to prevent abuse. \textit{Cf.} Section 475(c)(4), exempting certain trade receivables from mark-to-market treatment.

\textsuperscript{162} See, e.g., David S. Miller, \textit{A Progressive System of Mark-to-Market Taxation}, 109 Tax Notes 1047 (2005) (arguing that mandatory mark-to-market accounting of derivatives for large companies and wealthy individuals would improve economic efficiency, fairness and tax abuse (…continued)
Assuming it is appropriate to expand the category of taxpayers eligible for Section 475(f), a question arises as to whether any minimum securities trading volume should be necessary for eligibility. While it would be possible to come up with a test that has a lower threshold than is presently applicable, the Committee believes that there is no clear reason why the election should not be available to holders of securities in general as long as their securities valuations are reliable and they are not permitted to mark to market certain securities and not others.

Options for Consideration

An option for consideration would be to repeal the trader business requirement for a Section 475(f) election. To eliminate the need for identifications and the risk of cherry-picking, the election would apply to all eligible securities (or commodities) held by the electing taxpayer, regardless of when acquired.\textsuperscript{163} Losses incurred as a result of marking these securities (or commodities) to market would give rise to above-the-line deductions under Section 162.

Under this option, Section 475(f) would continue to reference the definition of securities in Section 475(c)(2) and the definition of commodities for electing commodities dealers in Section 475(e)(2).\textsuperscript{164} Consideration could be given to limiting the scope of the Section 475(f) mark-to-market election to a specified subset of securities (or commodities) that are eligible for mark-to-market treatment in the hands of dealers. In particular, the Section 475(f) election could be limited to securities (or commodities) that are publicly traded or whose end-of-year mark-to-market value is reported in an audited financial statement for the year in which the security (or commodity) is acquired.

\textit{Transitioning into Section 475(f) mark-to-market treatment}

Under the option discussed above, an electing taxpayer (including a trader) would be required to mark to market all of its securities (or commodities) for changes in value occurring after the date of election. It is necessary to have transition rules to address the built-in gain or loss that exists as of the date of election. There are three basic approaches. First, the built-in gain or loss as of the date of the election could be treated as a Section 481(a) adjustment.\textsuperscript{165} Second,

\textsuperscript{163} Consideration should be given by Treasury to the proper treatment of securities held by related taxpayers and whether in some instances they should also be required to be marked to market to prevent abuse, which is also an issue under current law.

\textsuperscript{164} Because the proposal does away with the trader nexus, it may be appropriate to revisit whether certain assets that heretofore were unlikely to be held in direct connections with a trader business and therefore were unlikely to be marked by an electing trader are appropriately treated as Section 475(c)(2) securities. For example, interests in partnerships that hold only securities and/or variable annuity contracts could be considered securities under the “derivative” prong of the current definition. \textit{See} Section 475(c)(2)(E). It may be appropriate to exclude these types of securities from the election.

\textsuperscript{165} \textit{Cf.} Rev. Proc. 99-17, 1999-1 C.B. 503 (under current Section 475(f), electing traders take into account built-in gain or loss as a Section 481(a) adjustment).
net built-in gain or loss could be taken into account immediately under a deemed sale-and-repurchase model. Third, the net built-in gain or loss could be taken into account under a so-called mark-and-freeze methodology where the built-in gain or loss is computed on an asset-by-asset basis and taken into account when those assets are eventually disposed of. A fourth model might be to require net gain to be taken into account currently and net loss to be spread over some period of years.

Character of transition gain or loss must also be considered. Regardless of when the built-in gain or loss is taken into account, the character of the individual items comprising the built-in gain or loss ought to be determined by reference to a hypothetical sale or exchange of the securities (or commodities) as of the effective date of the election. It may be desirable to have an exception to this general rule for gain or loss attributable to debt instruments that are not distressed. With debt of this type, gain or loss realized upon the transition arguably should be ordinary (even if a sale as of the date of election would have produced a capital item) in order to match the character of future accruals and/or mark-to-market adjustments to the character of the built-in gain or loss. For example, consider an electing taxpayer with a portfolio of debt instruments held as capital assets and purchased and carried at par but trading at a premium. If a Section 475(f) election is made, a built-in gain will be computed and taken into account. Going forward the securities would produce a loss (or bond premium deductions) equal to the built-in gain. To match the character of the built-in item to the inevitable reversal, the built-in item arguably ought to have ordinary character.

D. Other Options

1. Modernize Section 1091

Present law

The wash sale rules prevent a taxpayer from generating deductible losses with respect to stock, securities and certain related transactions if the loss arises in a transaction in which the taxpayer, broadly speaking, has not meaningfully changed its economic position within a specified period before and after the realization of the loss.

The principal operative provision applies when stock or securities are sold at a loss, and the taxpayer within a 30-day period before or after the sale date (the “window period”) acquires substantially identical stock or securities, or enters into a contract or option to acquire such stock or securities. In such a case, the loss generally is not allowed, the basis of the sold property carries over to the replacement property, with adjustments reflecting any differences between the sale price and purchase price, and the holding period of the sold property also tacks to the holding

166 See, e.g., Treas. Reg. §§ 1.1092(b)-3T(b)(6) & -4T(c)(5) (requiring built-in gain or loss on positions placed in identified mixed straddles and identified mixed straddle accounts to be recognized currently).

167 See, e.g., Section 475(b)(3).

168 This is a change from current law. Under Rev. Proc. 99-17, 1999-1 C.B. 503 (Feb. 9, 1999), an electing trader treats the built-in gain or loss as a section 481(a) adjustment that has ordinary character, regardless of whether a sale of the assets immediately before the election would have produced capital gain or loss.
period of the replacement property. Special rules apply if the amount of replacement property acquired is more than, or less than, the amount of loss property sold, under which generally a “first in time” rule applies. The term “stock or securities” includes contracts or options to acquire or sell securities. The wash sale rules were amended in 2000 in order to apply the rules to securities futures contracts and other cash-settled contracts.

The wash sale rules also apply to a loss realized on the closing of a short sale if within the window period substantially identical stock or securities are sold, or another short sale of stock or securities was entered into. These rules apply to dispositions and acquisitions of short positions in securities futures contracts.

Reasons for change

The wash sale rules date from the 1920’s. While they have been amended from time to time in recent decades, they do not capture the full spectrum of transactions that raise wash sale issues. There are also a number of technical issues with the wording of the wash sale rules that should be resolved.

In their current form, the wash sale rules operate as a relatively narrow, bright line set of rules. They are narrow because they apply primarily when property acquired by the taxpayer is identical, or substantially identical, to property sold by the taxpayer. The bright line nature of the rules makes them arbitrary, on the one hand, but administrable, on the other hand. Modernization of the wash sale rules could be accomplished by adopting a different, broader approach, that would disallow losses even when taxpayers make a more meaningful change to their economic position. Alternatively, it could be accomplished within the current narrow framework by making only targeted “fixes” to current gaps and uncertainties in the rules. Because the wash sale rules generally are viewed as having achieved their intended effect, in an administrable way, for those transactions to which they apply, the proposals below are based on the second approach.

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169 Section 1091(a) (loss disallowance); Section 1091(d) (basis carryover); Section 1223(3) (holding period).

170 Section 1091(b) & (c); Treas. Reg. § 1.1091-1(c) & (d). Under these rules, if a taxpayer sells 100 shares of stock at a loss, and within the window period carries out more than one transaction in which it acquires or enters into a contract or option to acquire that stock, generally the acquisition transactions are matched with the sold shares in the order in which they were entered into.

171 Section 1091(f).

172 Section 1091(e).

173 The concerns described in this paragraph have been discussed in a number of articles, including Lucy W. Farr & Michael S. Farber, Dirty Linen: Airing Out the Wash Sale Rules, Tax’n Fin’il Prods 41 (Summer 2002); Erika W. Nijenhuis, Wash Sales Then and Now, Tax’n Fin’il Prods 43 (Fall 2003); David Schizer, Scrubbing the Wash Sale Rules, 82 Taxes 67 (2004).

174 By comparison, a number of other rules of the Code come into effect if a taxpayer takes a position that is “substantially similar or related property” to stock held by the taxpayer. See Section 246(c)(4)(C); Section 901(k); Section 1(h)(11).
Stock or securities

The wash sale rules apply to losses realized on the sale or other disposition of “stock or securities,” including contracts or options to acquire or sell stock or securities. The terms “securities” and “contracts or options to acquire or sell” are not defined for this purpose, and no consistent definition has emerged from case law or the Service’s ruling practice. Thus, there is uncertainty as to the scope of the rules, for example with respect to equity swaps. Moreover, wash sale issues may be raised by transactions in financial instruments that are not treated as “stock or securities,” such as transactions in commodity derivatives or in exchange-traded equity of a publicly traded partnership like a master limited partnership.

In addition, the wash sale rules by their terms apply only if the taxpayer “acquires,” or enters into “a contract or option so to acquire,” replacement property, thus limiting the types of replacement transactions that trigger the wash sale rules. For example, a call option written by a taxpayer is not an option acquired by the taxpayer and is not an option to acquire property.175

Contract or option as replacement property

The treatment of contracts or options to acquire stock or securities as transactions that trigger the operation of the wash sale rules is potentially too broad. The wash sale rules properly apply if a taxpayer sells stock and within the window period enters into a contract or option to acquire the same stock that is likely to be exercised, because the taxpayer will be in the same economic position before and after the sequence of transactions if it acquires the stock by exercise of the option. If the option is unlikely to be exercised, however, the taxpayer has materially changed its economic position and is unlikely to reacquire the stock, raising questions about whether it is appropriate for the wash sale rules to apply. Moreover, if the taxpayer first purchases an out-of-the-money option and then within the window period repurchases the stock (not pursuant to the option), the taxpayer may be able to deduct the original loss when the option expires if the form of the transaction is respected and the taxpayer’s basis in the sold property carries over to the option.

In addition, it is not certain how the wash sale rules should apply if a taxpayer sells a stock or security at a loss and then enters into a contract or option to acquire a basket of stocks or securities that include the loss property sold. For example, a taxpayer may take the position that if it sells XYZ stock at a loss, and within the window period enters into an equity swap on a basket of stocks including XYZ, the transaction is not subject to the wash sale rules if the basket as a whole differs substantially from XYZ stock.176

Short positions

The wash sale rules apply if a taxpayer closes a short sale or terminates a short securities futures contract position and replaces it with another short sale or short securities futures contract

175 See T.A.M. 7730002 (Apr. 14, 1977) (entry into written call option is not a wash sale).

176 Cf. Treas. Reg. § 1.246-5(c)(1) (for purposes of rules limiting the availability of the dividends-received deduction, a position that reflects the performance of a basket of 20 or more stocks generally is not “substantially similar or related property” to any one stock held by the taxpayer as long as the basket does not substantially overlap with the stock).
position. The rules do not specifically refer to other types of short positions, such as the purchase of a put option or entering into a forward contract to sell securities.\textsuperscript{177}

\textit{Substantially identical standard}

The meaning of the “substantially identical” standard is articulated in regulations and in case law.\textsuperscript{178} Under the leading case in the area, two assets are substantially identical where there is an “economic correspondence [between them] exclusive of differentiations so slight as to be unreflected in the acquisitive and proprietary habits of holders of stocks and securities.”\textsuperscript{179} This standard, which is based on whether as a real-world matter taxpayers ordinarily consider the two assets to be functionally identical, generally has provided sufficient guidance, particularly when considered with a number of authorities that have applied the standard to specific facts.\textsuperscript{180} Accordingly, the wash sale rules apply to prevent taxpayers from harvesting losses when they have made no meaningful change to their economic position.

There are circumstances, however, where it is not clear how the standard should be applied. One such case is where the taxpayer disposes of, or acquires, an interest in multiple stocks or securities at the same time. For example, if a taxpayer sells an S&P 500 index mutual fund and within the window period buys an S&P 500 index mutual fund from another fund group, under current law the transaction may or may not be a wash sale. Another case is when the assets disposed of or acquired constitute derivative financial instruments. For example, if a taxpayer disposes of an option on stock at a loss, and purchases another option on the same stock, perhaps with a different strike price or expiration date, no guidelines exist to determine whether the two options are “substantially identical.”\textsuperscript{181}

\textbf{Options for Consideration}

\textit{Stock or securities}

An option would be to expand the term “stock or securities” to include derivative financial instruments, including derivative instruments relating to underlying risks other than stock

\textsuperscript{177} \textit{Cf.} Section 1233(b), flush language (acquisition of an option to sell property at a fixed price treated as a short sale for section 1233 purposes), section 1233(c) (limiting the scope of section 1233(b)). Section 1233(b) generally is thought to have been superseded by the straddle rules of section 1092. See section II.B.2 of this submission.

\textsuperscript{178} \textit{See} Treas. Reg. § 1.1233-1(d)(1); \textit{Hanlin v. Commissioner}, 108 F.2d 429 (3d Cir. 1939).

\textsuperscript{179} \textit{Hanlin}, 108 F.2d at 430.

\textsuperscript{180} As applied by those authorities, it is relatively rare for two assets to be treated as substantially identical. \textit{Compare} Rev. Rul. 77-201, 1977-1 C.B. 250 (convertible preferred stock is substantially identical to underlying common stock where preferred stock trades as common stock equivalent) and \textit{Margaret E. Kidder}, 30 B.T.A. 59 (1934) (non-voting trust certificates were substantially identical with the underlying stock) \textit{with Seymour H. Knox}, 33 B.T.A. 972 (1936) (stock of an operating company was not substantially identical to the stock of a holding company whose sole asset was the stock of the operating company).

\textsuperscript{181} G.C.M. 38285 (Feb. 22, 1980) recommended issuing a ruling that options identical in all respects other than strike price should be treated as “substantially identical.” This rule, however, was never included in any published guidance.
or debt. For example, the wash sale provision could be expanded to cover transactions in commodity derivatives and other liquid financial instruments. One possible approach would be to redefine the scope of the wash sale rules so that they apply to any “security” within the meaning of Section 475(c)(2) (without regard to Section 475(c)(2)(F)) or any “commodity” within the meaning of Section 475(e)(2) (without regard to Section 475(e)(D)), other than any security or commodity that is marked to market for tax purposes, whether mandatorily or by taxpayer election. Treasury should have authority to expand the scope to other derivative financial instruments and evidences of interest therein. It should not matter for this purpose whether the instrument is one that is “acquired” or otherwise entered into.

If this option is adopted, corresponding changes will need to be made to the basis and holding period rules to ensure that the wash sale rules continue to apply effectively as deferral, rather than disallowance, provisions.

Contract or option as replacement property

While the conceptual basis behind the contract or option rule is not entirely consistent with the premise that the wash sale rules should apply only when a taxpayer has not materially changed its economic position, in practice the rule generally is well understood and easy to apply. Moreover, it serves to discourage taxpayers from entering into wash sales by eliminating their ability to retain the potential for increases in value in the sold stock or security during the window period. Accordingly, we believe that only limited changes to this rule are necessary. As an initial option for consideration, the term “contract or option to acquire” might be replaced or modified to make clear that entering into a notional principal contract or other derivative financial instrument that does not provide for a taxpayer to “acquire” the underlying asset but that provides “long” exposure to a sold asset will trigger the wash sale rules if entered into within the window period. An additional option would be to grant Treasury explicit authority to disregard an out-of-the-money option if it is entered into primarily for the purpose of allowing a loss from the sale of stock or securities to be deducted that would otherwise be subject to the wash sale rules.

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182 This proposal is made to address the fact that the statutory definitions of “security” and “commodity” may not clearly capture every type of risk on which derivative financial instruments are written. For example, a weather swap is not a “security” and may not be a “commodity.”

183 Under current law, it is not certain whether the basis of sold property carries over to a contract or option to acquire that property, as a result of the way that Section 1091(d) is phrased (basis of sold stock or securities carries over to substantially identical stock or securities acquired). The Service has also taken the position that basis does not carry over to a taxpayer’s investment in an IRA when a taxpayer sells stock at a loss and repurchases it in its IRA. Rev. Rul. 2008-5, 2008-3 I.R.B. 271. We believe that basis always should carry over to replacement property. Accordingly, Section 1091(d) should be revised to make that result clear. A similar change should be made to the holding period rule of Section 1223(3).

Rev. Rul. 2008-5 also raises a larger issue, which is whether Section 1091 should apply to transactions between related parties. That function is principally carried out today by Section 267, and, in the case of sales between partners and partnerships, Section 707. However, Sections 267 and 707 can operate to disallow a loss permanently, while the wash sale rules merely defer the loss. We suggest that consideration be given to expanding the scope of Section 1091 to sales of loss property to a related party, and correspondingly narrowing the scope of Sections 267 and 707.
In the case of a contract or option on a basket of stocks or securities, another option would be to give Treasury the authority to determine when the wash sale rules should apply. In general, we think that the rules for applying the “substantially identical” standard of the wash sale rules should be no broader than the “substantially similar or related property” test applicable for purposes of Section 246, since “substantially identical” is a more difficult standard to meet than “substantially similar or related property.”

Short positions

As an additional option for consideration, the wash sale rules should apply to losses derived from any short position, including short derivative financial instruments in commodities, in parallel with the scope of the proposed expansion of the wash sale rules to losses from long positions. Accordingly, a loss from the termination of a short position of any kind would be disallowed if a taxpayer acquires or enters into a substantially identical short position. The wash sale basis and holding period rules should be revised to make clear how they apply in the case of losses from short positions.

Because section 1091(e) currently does not apply when a taxpayer closes out a short position and enters into a new short position other than a substantially identical new short sale or short securities futures contract, and because the wash sale rules are intended to apply to transactions in which taxpayers do not materially change their economic position, we do not propose to add the equivalent of a “contract or option to acquire” provision to the wash sale rules for short positions. We are not aware of any abusive transactions involving the closing of a short sale and entering into a non-substantially identical replacement position. However, Treasury should have authority to provide rules to address any abuses that may materialize.

Substantially identical standard

As described above, while the Hanlin standard as supplemented by later cases and rulings generally provides sufficient guidance, there are a number of circumstances for which the application of the standard should be clarified.

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184 In addition, Section 1091(e)(1) should be repealed as surplusage. The legislative history of that provision is sparse, but a description of its purpose is provided in James W. Wetzler, *The Tax Treatment of Securities Transactions Under the Tax Reform Act of 1984*, 25 Tax Notes 453, 469-70, 472-73 (1984). According to the Wetzler article, Section 1091(e)(1) was enacted to address certain short-against-the-box transactions that were closed out in a manner that straddled the end of the taxable year, which under prior law allowed a taxpayer to recognize a loss in one year and an offsetting gain in the following year under certain circumstances. Section 1091(e)(1) is no longer necessary to defer the loss as a result of subsequent changes to the law. If the taxpayer closes out both positions in the same year, Section 453(k)(2) now generally provides that both gain and loss on such transactions must be taken into account in the first year. If instead a taxpayer were to close out only the loss position in the current year and hold the gain position until the following year, the straddle rules would defer the loss. Thus, in either case the gain and loss would be taken into account in the same year.

185 If Section 1091(e) is expanded in this manner, it would be possible for both Section 1091(a) and Section 1091(e) to apply to some transactions, for example the disposition of a purchased put option at a loss followed by the purchase of a substantially identical put option, since a purchased put option on stock is a “security” and would presumably also be treated as a short position. We recommend that only one subsection of Section 1091 apply to such transactions.
Stock of one company ordinarily is not treated as substantially identical to stock of another company, unless one is convertible into the other and the relative values, price changes and other circumstances are such that they trade as essentially the same stock.\footnote{186} Moreover, generally there is no “look-through” to the assets of a corporation.\footnote{187} Under these rules, stock of one mutual fund generally is not treated as substantially identical to the stock of another mutual fund. In the case of actively managed mutual funds, where performance and fees may vary substantially even for funds in the same sector, that result is consistent with the general “substantially identical” standard. In the case of passive index funds, however, a different rule may be appropriate as it is less likely that investors perceive significant differences between them.

In the case of derivative financial instruments, there is very little law on how to determine when financial instruments other than debt or stock are considered substantially identical to each other – for example, when a change to the terms of a swap, forward or option is sufficiently immaterial that the modified instrument should be treated as not differing materially in kind or extent from the unmodified instrument. It is also difficult to analogize from the standards that apply to debt or stock because the ways in which financial instruments differ from each other do not necessarily correspond to the variances between different debt instruments or shares—for example, there is no analogy to the strike price on an option – and even when there are similar legal differences they may not have the same economic significance.

Accordingly, as an additional option for consideration, the expansion of the wash sale rules with respect to derivative financial instruments might be coupled with a grant of authority to Treasury to determine when such an instrument is substantially identical to another such instrument or to the underlying asset. In addition, if this option is adopted, we urge that legislative history provide guidance to Treasury in formulating its rules, which could describe factors that Congress expects would or would not be taken into account and provide some examples in order to illustrate Congressional intent. Legislative history of this kind would also be important in order to enable taxpayers to comply with the law prior to the issuance of regulations. The legislative history of Section 1259 would be a useful model for legislative history in this area.

In our view, the overall standard for determining whether two derivative financial instruments are substantially identical to each other should be the same – that is, whether investors ordinarily view the instruments as essentially identical – as it is under current law. We believe that the value of the instrument and important terms such as the underlying asset, the maturity of the instrument and, in the case of options, the strike price of the option and whether the option is in- or out-of-the-money, are factors that typically would be taken into account in determining whether two financial instruments are substantially identical as an economic matter.\footnote{188}

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\footnote{186} Treas. Reg. § 1.1233-1(d)(1); Rev. Rul. 77-201, 1977-1 C.B. 250.

\footnote{187} Seymour H. Knox, 33 B.T.A. 972 (1936).

\footnote{188} Other factors such as liquidity and embedded leverage do not seem relevant to the policies of the wash sale rules.

Whether to take into account the identity of the counterparty is a more difficult issue, as credit risk is a material risk for derivative financial instruments. However, unlike the case of a debt instrument, the primary drivers of a derivative’s value will be its underlying reference property and its contractual terms (e.g., strike price), at least outside the case where the counterparty is distressed. Accordingly, for non-debt financial instruments credit risk should not be relevant unless there is a “change in payment expectations” as provided in Treas. Reg. § 1.1001-3(e)(4) for debt instruments. Under an approach of this kind, if a taxpayer terminates an (…continued)
Because the bright line nature of the wash sale rules is important to their administrability, it is important to provide examples or safe harbors even if they do not cover every case. For example, if a taxpayer enters into a rolling series of one-month forward contracts on a commodity, each contract relates to a distinct period of time. When contract #1 is about to expire, one would not expect an investor to view that contract as similar to contract #2 maturing a month later. A loss on contract #1 therefore should not be disallowed under the wash sale rules. On the other hand, if a taxpayer has a position in a long-dated swap, and replaces it today with another long-dated swap with a different maturity, the distant nature of the maturity date makes the change in maturity less significant.

Options are more complex instruments than instruments like forwards, futures or swaps that provide complete “upside” and “downside” exposure to the underlying asset. Options have more variables affecting their value, so that devising a precise test for options is challenging. Very generally, the value of a conventional option is determined by reference to (a) whether the strike price for the option (generally, the price at which a holder of the option may buy or sell the underlying property) is greater or less than the current fair market value of the underlying property, and (b) the remaining term of the option because both of those factors affect the likelihood that the option will be exercised. Thus, the relative strike prices and maturities of options are generally significant in determining whether investors consider them to be

(continued…)

interest in an option written by Dealer X at a loss, and replaces it with an identical option written by Dealer Y, and both Dealer X and Dealer Y are creditworthy financial institutions, the wash sale rules would apply. Cf. Temporary Treas. Reg. § 1.1001-4T (assignment of derivative financial instrument from one dealer to another does not give rise to deemed exchange, subject to certain conditions that do not include an evaluation of credit risk). But cf. Corn Products Refining Co., 16 T.C. 395 (1951) (holding that corn futures contracts were not substantially identical in part because “it would be purely accidental if the new contract was with the same party as the one who had agreed to sell the commodity in the earlier contract”). If however Dealer X were Lehman and the termination was the result of Lehman’s bankruptcy, the wash sale rules would not apply to the loss from terminating the option.

See Section 1233(e)(2) (futures maturing in one month not treated as substantially identical to futures maturing in a different month).

Cf. Hanlin, 108 F.2d 429 (3d Cir. 1939) (differences in bond call dates or maturities that are many years distant are unlikely to be considered economically significant).

The difference between an option’s strike price and the value of the underlying asset is its “intrinsic value.” For example, if a taxpayer holds a call option to buy XYZ stock for $100, and the stock is currently trading at $110, the option has $10 of intrinsic value.

The remaining time to maturity of an option affects its “time value.” The time value of an option is the difference between the value of the option if purchased or sold today and its intrinsic value. Time value takes into account the possibility that the option will be exercised even if it is not currently in the money. For example, if the option described in note 192 were exercisable tomorrow its time value would be very different from its time value if it were not exercisable for a year, because the closer the option is to the exercise date the less uncertain it is whether the option will be exercised. Time value thus is determined by reference to both remaining time to maturity and how deeply in or out of the money the option is, and is greatest when an option is “at the money” (meaning that its strike price equals the current fair market value of the underlying asset).
substantially identical. Another way to compare options is to ask whether changes in the value of
the options as a result of a change in value of the underlying property could be expected to be
substantially identical over a wide range of potential changes in value. This change-in-value
test may be particularly useful for put options that have strike prices that are substantially higher
than, and call options with strike prices substantially lower than, the current fair market value of
the underlying property, because options of that kind are more likely to be comparable as an
economic matter to an outright long or short position in the underlying property and relatively
insensitive to changes in strike prices and maturities. For options that are closer to at-the-money,
the change-of-value test ordinarily would not be met unless the strike prices and maturities
of the options being compared were very close, which may well be an appropriate result.
Whatever the test, it will be important to include either safe harbors or examples in the legislative
history so that taxpayers can properly apply the test prior to the issuance of detailed regulatory
guidance.

Once a “substantially identical” standard for derivative financial instruments has been
formulated, we think that the same standard should be used to determine whether a derivative
financial instrument is substantially identical to the underlying stock or security for purposes of
the situation where a derivative has been disposed of an the underlying stock or security
acquired.

Contract or option concept when sold property is a derivative financial instrument

We have considered at length whether and how the concept that a “contract or option to
acquire” sold property triggers the wash sale rule should apply when the sold property is a
derivative financial instrument. Under current law, while such a rule applies, it has essentially no
effect as a practical matter. For example, a taxpayer that wishes to terminate its interest in an
option on ABC stock in order to recognize a loss in the option while retaining exposure to ABC

193 More technically, this approach asks whether the delta of the options is similar over a
wide range in values. Delta refers to the degree of correspondence between an $X change in the
value of the underlying asset and the change in value of the option. It is sometimes used as an
approximate surrogate for the probability that an option will be exercised, because an option with
a delta close to 1 is virtually certain to be exercised while an option with a delta close to zero is
virtually certain not to be exercised.

194 Any two options on the same underlying property will change in value proportionately
to changes in the value of the underlying property (although not necessarily the same proportion),
therefore proportionately to one another. Thus, measuring whether the change in value remains
proportional over a wide range of changes in value is a very useful way to identify options that
truly are substantially identical.

195 Such a test would also have the virtue of being applicable to many types of complex
derivatives, not just to simple options.

196 A possible approach would be to provide that, if the old position and the new position
have the same or substantially identical underlying stock or security and have (a) strike prices
within X percent of each other and (ii) maturities within Y period of each other, the positions are
presumed to be substantially identical.

197 Cf. Rev. Rul. 77-201, 1977-1 C.B. 250 (convertible preferred stock is substantially
identical to the underlying common stock if, among other matters, it sells at prices that do not vary
significantly from the number of shares of common stock into which it can be converted).
stock may enter into a similar replacement option on ABC stock. If the two options are substantially identical, then the “contract or option to acquire” language is not necessary or relevant to disallow the loss. That is, the transaction is subject to the wash sale rules in the same way that selling ABC stock and then buying ABC stock would be. If the two options are not substantially identical, then under current law the taxpayer is entitled to take the loss, subject to any common law doctrines, because the taxpayer has actually acquired the new option, rather than entering into a “contract or option to acquire” the new option. That is, the “contract or option to acquire” language is not relevant because the taxpayer has not entered into a contract today to acquire the new option in the future; instead, its second transaction is the completed purchase of the new option. 198

Expanding the wash sale rules to apply when a taxpayer terminates its interest in a derivative financial instrument and enters into the economic equivalent of a “contract or option to acquire” that instrument would be consistent with the rules that apply when sold property is an equity or debt instrument. However, we believe that such a rule in practice would result in disallowing a loss from a derivative financial instrument whenever the taxpayer enters into another derivative financial instrument on the same underlying asset within the window period, even if the new instrument unquestionably gives rise to a materially different risk exposure. This would be a very significant expansion of the wash sale rules, because it would have the effect of writing the “substantially identical” standard out of the statute if the sold property were a derivative financial instrument. On balance, because we are not aware of abuses involving transactions of the kind described in the paragraph above, we do not recommend any option to expand these rules. That is, we believe that the “contract or option to acquire [or other long derivative on the same underlying asset]” standard should apply when the sold property is stock, a security or a commodity, but not when it is a derivative financial instrument. When the sold property is a derivative, we believe that the “substantially identical” standard should apply to test the relationship between the sold property and the acquired property. However, we believe an appropriate option would be to give Treasury authority to expand the rule if necessary to prevent abuse.

2. Modernize and expand Section 1032

Present law

Pursuant to Section 1032, a corporation does not recognize gain or loss on the issuance of its stock. 199 As originally enacted, Section 1032 provided that a corporation would not recognize gain or loss on the “receipt of money or other property in exchange for stock (including treasury stock) of such corporation.” The statutory scope of Section 1032 has been expanded over time to cover additional situations, including a corporation’s repurchase of options on its stock and transactions involving certain securities futures contracts. 200 In addition, Section 1032 has been interpreted by Treasury and the Service to cover certain additional situations, including the

198 Similarly, if a taxpayer today were to close out an equity swap on XYZ stock and then purchase a call option on XYZ stock, we do not believe that the wash sale rules currently would disallow a loss on the swap.

199 Section 1032(a).

200 See House Report 98-432 (part 2), 98th Congress, 2d Session (1984) (in 1984, Congress added what is now the second sentence of Section 1032(a), without the reference to securities futures contracts); General Explanation of Tax Legislation Enacted in the 106th Congress (Apr. 19, 2001) (in 2000, Congress added the reference to securities futures contracts in the second sentence of Section 1032(a)).
issuance of stock in exchange for services, the issuance by a corporation of stock in exchange for shares of its own stock, and the cash settlement by a corporation of a written put option on its stock.

Reasons for change

Commentators have noted that there are a number of uncertainties and inconsistencies in the existing framework under Section 1032. For example, it is not clear whether Section 1032 applies to: (i) the cash settlement by a corporation of a forward contract (whether pursuant to its terms or by negotiated settlement) written on the corporation’s stock, (ii) the cash settlement of an option acquired by a corporation with respect to its own stock, or (iii) payments to or by a corporation on a swap or other contract that are determined by reference to the value of the corporation’s stock. While the literal statutory language does not appear to address these transactions, common law authorities predating Section 1032’s enactment held that transactions by a corporation relating to the corporation’s own stock—including certain transactions where no stock was actually issued—were “capital” in nature and did not give rise to income or loss. A number of private rulings have addressed certain of the circumstances discussed above where it is not clear whether Section 1032 applies to the transaction, generally holding that no gain or loss was recognized.

In light of the current uncertainty about whether Section 1032 applies to a specified transaction, a corporation that is in a “loss” position with respect to the transaction might take the position that Section 1032 does not apply, while a corporation that is in a “gain” position with respect to the transaction might take the opposite approach. When amending the scope of Section 1032 in 1984, Congress specifically stated that it intended to limit this type of “whipsaw” against the government.

While a legislative response to this uncertainty could aim to narrow the scope of Section 1032, so that it applied only to actual stock issuances but not to the cash settlement of any derivatives linked to the corporation’s stock, such a choice would cause transactions that are economically equivalent to result in very different tax consequences. For example, a corporation that entered into an option to sell its stock, where the settlement mode was at the corporation’s

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201 Treas. Reg. § 1.1032-1(a).
202 Treas. Reg. § 1.1032-1(b).
204 See generally New York State Bar Association Tax Section, Report on Section 1032 (June 15, 1999); Michael L. Schler, Exploring the Boundaries of Section 1032, 49 Tax Lawyer 543 (1996).
205 See, e.g., Illinois Rural Credit Association, 3 B.T.A. 1178 (1926) (holding that receipt by a corporation of partial payment in subscription for its stock was not taxable income because the payment was to provide capital for the corporation).
election, could physically settle the contract if it appreciated (thereby recognizing no gain under Section 1032) or cash settle the contract if it depreciated (recognizing loss). Alternatively, it would be possible to create a rule that treated the physical settlement of any derivative on a corporation’s own stock as a deemed cash settlement coupled with an on-market sale (or purchase) of stock for cash. However, this approach would not only depart from the existing statute and the early case law on the topic, but it would also differ from the treatment of physically settled derivatives on other types of property.

In one of the rulings addressing Section 1032’s scope, the Service described “[i]ts view that Congress did not intend § 1032 to be elective or to be avoided by economically equivalent transactions, and that it should be applied broadly . . . [T]he overriding principle that is present in the Service’s rulings and the history of § 1032 . . . is that when taxpayers engage in transactions that result in a gain or loss that is based on the value of their own stock, § 1032 requires nonrecognition of such gain or loss.”

We agree with the Service’s decision in those private rulings to apply Section 1032 broadly. To promote consistency and the promulgation of clear rules of general application, an option would be to broaden Section 1032 legislatively.

Option for Consideration

In order to limit whipsaw against the government and to promote consistency in the tax treatment of economically equivalent transactions, Section 1032 could be broadened to include income, gain, loss and deduction where such items arise out of (i) an option, forward or futures contract, to the extent such option or contract relates to the corporation’s stock, or (ii) any contract or other position to the extent that such items reflect (or are determined by reference to) changes in the value of the corporation’s stock.

We note that under current law and even under this possible expansion of Section 1032 significant technical and policy questions would remain regarding the precise scope of Section 1032. For example, consideration should be given to the treatment of derivatives that relate in part to a corporation’s stock and in part to some other asset, to the consequences that arise when as the result of a merger or other event a derivative contract no longer relates to the stock of the taxpayer and to the proper timing and character of non-stock linked payments on a complex derivative such as a notional principal contract on a corporation’s own stock. We think, however, that these issues are best addressed by Treasury in regulations, and the need for their resolution does not undermine the rationale for expansion of Section 1032 in the manner proposed.

3. Treatment of swap expenses as above-the-line deductions

Present law

A notional principal contract (“NPC” or “swap”) is a bilateral contract where one party makes periodic payments determined by applying a rate or formula to a notional amount in exchange for specified consideration. One common example is an “interest rate swap” where one party agrees to make periodic payments determined by applying a fixed rate to the notional principal amount in exchange for periodic payments equal to the product of a floating rate and the same notional amount. Such a swap is commonly referred to as a “fixed-for-floating” interest rate swap.

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208 C.C.A. 200832022 (Apr. 23, 2008).

209 See Treas. Reg. § 1.446-3(c)(1)(i).
Swaps are often used to manage economic exposures created by assets or liabilities. For example, an entity that invests in floating-rate bonds may borrow at a fixed rate to fund its investments. To better match the interest-rate risk with respect to the borrowing with that of the assets, the entity may choose to enter into a floating-for-fixed swap.

In other cases, swaps are used to gain economic exposure to particular assets. For example, an investor seeking exposure to the S&P 500 stock index can enter into a “total return” swap where the investor makes periodic payments equal to a floating rate applied to a notional amount and receives periodic payments equal to the change in value of an investment in the S&P 500 having an initial value equal to the notional amount.

Regulations under Section 446 provide detailed tax accounting rules for swaps. The net periodic payment in each period is taken into account for tax purposes in the taxable year to which it relates. Non-periodic payments are allocated to the taxable years under detailed rules and, once allocated, adjust the net income or expense for the relevant year. Each swap produces a single item of net income or expense for the year.210

If a swap is entered into by an individual or a partnership other than in connection with a trade or business, any net expense item would be a Section 212 expense (expense for the production of income outside of a trade or business). Because swap expenses are not enumerated in Section 62(a), they are below-the-line expenses allowable as itemized deductions. Because swap expenses are not enumerated in Section 67(b), they are miscellaneous itemized deductions subject to the 2% floor on miscellaneous itemized deductions.

**Reasons for change**

The 2% floor on miscellaneous itemized deductions was enacted as a simplification measure, to relieve taxpayers of recordkeeping obligations and to relieve the Service of enforcement and administrative burdens in respect of items that are typically small and as to which taxpayers are prone to error regarding their deductibility.211 Examples of investment expenses to which the provision is aimed are investment advisory fees, subscriptions to investment advisory publications, certain attorneys’ fees, and the cost of safe deposit boxes.212

As bilateral, often multi-year contracts, swaps are very different from the types of expenses for which the provision was intended. First, subjecting losses on swaps to the 2% floor will not meaningfully reduce recordkeeping or auditing burdens, since the Service, in the event of an audit, and the taxpayer will likely need to track items on the swap to determine if there is net income or loss in the first place, and to account for any nonperiodic payments that could affect subsequent years.

More significantly, under current law a taxpayer may recognize income on a swap in some years but suffer non-deductible losses on that same swap in other years, with the result that the taxpayer’s overall net income inclusion on the swap does not accurately reflect its economic income—a distortive result at odds with any rational policy. This problem will become more significant if the Service makes final proposed regulations in respect of contingent nonperiodic payments on swaps, because those regulations can, depending upon the particular facts involved,

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210 *See* Treas. Reg. § 1.446-3(d)-(f).

211 *See*, *e.g.*, Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986.

212 Treas. Reg. § 1.67-1T(a)(1)(ii).
require “phantom” ordinary inclusions or deductions that can be reversed in subsequent years.\textsuperscript{213} In fact, the Service has recognized in the context of contingent payment debt instrument that ordinary losses on a financial instrument should not be treated as miscellaneous itemized deductions by exempting “negative adjustments” on these instruments from the miscellaneous itemized deduction rules.\textsuperscript{214}

Outside of the trade or business context (where swap expenses would give rise to an above-the-line Section 162 deduction), swaps are typically entered into in order to (i) manage funding costs and/or (ii) increase or decrease investment exposure to specified assets. The interest expense managed by an interest rate swap is not subject to the 2% floor (see Section 67(b)(1)). Investment losses are also typically capital and therefore above-the-line (see Section 62(a)(3)). Swap expenses are more akin to these expenses than to other common Section 212 expenses described above.

For these reasons, and because there is no affirmative policy rationale for treating them as miscellaneous itemized deductions, an option would be to treat swap expenses as above-the-line deductions.

\textbf{Option for Consideration}

Section 62(a) could be amended to treat swap expenses as above-the-line deductions.

\textsuperscript{213} Prop. Treas. Reg. § 1.446-3(g)(6).

\textsuperscript{214} Treas. Reg. § 1.1275-4(b)(6)(iii)(D).