December 30, 2013

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: Comments on the Camp Proposal to Reform the Taxation of Financial Products

Dear Chairmen and Ranking Members:

Enclosed please find comments on the proposal for the reform of the taxation of financial products (the “Discussion Draft”) issued by Chairman Dave Camp of the Ways and Means Committee (“Comments”). These Comments 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.

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

Sincerely yours,

Michael Hirschfeld
Chair, Section of Taxation

Enclosure

cc: Ms. Amber Cottle, Majority Staff Director, Senate Finance Committee
Mr. Christopher Campbell, Minority Staff Director, Senate Finance Committee
Ms. Jennifer Safavian, 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 Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
Honororable William J. Wilkins, Chief Counsel, Internal Revenue Service
Honorable John Koskinen, Commissioner, Internal Revenue Service
In January 2013, Chairman Dave Camp of the Ways and Means Committee issued a proposal for the reform of the taxation of financial products (the “Discussion Draft”). These comments (“Comments”) on the Discussion Draft 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 Comments were prepared by individual members of the Financial Transactions Committee of the American Bar Association Section of Taxation (the “Committee”). Overall responsibility for preparing these Comments was exercised by Matthew Stevens, the Chair of the Committee, who also exercised drafting responsibility for the mark-to-market generally. Drafting responsibility for the expanded hedging piece of mark-to-market, and for the hedging identification piece, was exercised by Chip Harter, Lena Hines, and Jared Hermann. Drafting responsibility was exercised for the portions dealing with debt instruments, by David Garlock and Eileen Marshall, weighted average basis, by Steve Rosenthal, and wash sales by Stevie Conlon, respectively. Substantial additional contributions were received from Dale Collinson, Robert Kantowitz, and Petya Kirilova. Special thanks are due to Darrell Doss, Lisa Kothari, and Andrew Reiter for making sure that these comments complied with the Section of Taxation’s formal requirements. These Comments were further reviewed by Lucy Farr, Council Director for the Committee, by George Howell, on behalf of the Committee on Government Submissions, by Eric Solomon, and by Michael Hirschfeld, as Chair of the Section of Taxation.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who may be affected by the federal tax principles addressed in these Comments or 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 Comments.

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Date: December 30, 2013
# Executive Summary of Committee Recommendations

1. Mark-to-Market of Derivatives ................................................................. 4
2. Allowing Financial Accounting Hedge Identifications to Qualify as Tax Hedge Identifications ................................................................. 4
3. Debt Related Issues .................................................................................. 5
4. Mandatory use of weighted average method of cost accounting for securities ........................................................... 5
5. Changes to the Wash Sale Rules ............................................................... 6

## Detailed Comments on Discussion Draft

1. Mark-to-Market Accounting ..................................................................... 7
   a. Mark-to-Market Accounting as the General Rule for the Taxing of Derivatives ........ 7
   b. Limitation to Derivatives With Actively Traded Underlying Assets .................. 16
   c. Derivatives embedded in debt ........................................................................ 19
   d. Treatment of certain positions as derivatives .................................................. 21
   e. Treatment of Mixed Straddles ................................................................. 23
   f. Other Straddle-related Issues Under a Mark-to-Market System ..................... 28
2. Book-Tax Conformity for Hedging Identification ..................................... 32
   a. Background ............................................................................................ 32
   b. Discussion Draft Proposal ....................................................................... 34
   c. Committee Comments on Discussion Draft Proposal ................................... 35
3. Modification to Treatment of Debt Instruments ....................................... 39
   a. Issue Price of New Debt Following a Modification .................................. 39
   b. Debt modifications should also be nontaxable exchanges for debt holders, with carryover basis ................................................................. 41
   c. Amortizable Bond Premium .................................................................. 44
   d. Market Discount Rules .......................................................................... 45
   e. Possible extension of maximum yield to all accruals on debt, whether stated interest, OID or market discount ................................. 49
   f. Character of loan losses ......................................................................... 50
g. Codification of the doubtful collectability exception (DCE) and its application to OID, market discount and issuers of debt ................................................................. 50
h. Exclusivity ..................................................................................................................... 51
i. Extension of Market Discount Rules to Certain Bonds Held by Partnerships .......... 51
j. Rules Governing Certain Government Debt ................................................................. 53

4. Mandatory use of weighted average method of cost accounting for securities ........... 53
   a. The Discussion Draft’s Proposal ............................................................................... 53
   b. Committee’s Comments ........................................................................................ 54

5. Wash Sale Proposal .................................................................................................... 60
   a. Discussion Draft Proposal ...................................................................................... 60
   b. Committee Comments on Discussion Draft Proposal ............................................. 63
Executive Summary of Committee Recommendations

1. Mark-to-Market of Derivatives
   a. The Committee considered the advantages and disadvantages of adopting a mark-to-market system for derivatives, but did not make a recommendation as to whether such a system should be adopted.
   b. If a mark-to-market system for derivatives is to be adopted, it should be limited to derivatives that are based on actively traded underlying assets.
   c. Rights or obligations embedded in a debt instrument should not be marked to market.
   d. Short positions (with the possible exception of a short position in a currency) should, but securities lending transactions should not, be marked to market.
   e. The Discussion Draft’s treatment of mixed straddles raises complex issues which the Committee was not able to resolve. However, the Committee did conclude that built-in gain should not be triggered under the mixed straddle rule upon entering into a derivative.
   f. Regarding the Discussion Draft’s proposed changes to the straddle rules, the Committee concluded that (i) the concept of an identified straddle should be retained, (ii) the rule requiring that a position with respect to stock could not be a position in a straddle unless the offsetting position were with regard to substantially similar or related property should be retained, and (iii) the rules governing qualified covered calls should be repealed.

2. Allowing Financial Accounting Hedge Identifications to Qualify as Tax Hedge Identifications
   a. The Committee supports the Discussion Draft’s proposal to allow a hedge identification made for financial accounting purposes to constitute a hedge identification for tax purposes.
   b. The inadvertent error exception should still be available where the taxpayer makes neither a financial accounting nor a tax hedging identification, if the derivative otherwise qualifies as a tax hedge and the taxpayer can meet the requirements of the inadvertent error exception.
   c. Where a taxpayer has relied upon a financial accounting hedge designation as its tax identification, a “de-designation” for financial accounting purposes should not affect the identification for tax purposes.
   d. In situations where a controlled foreign corporation’s (“CFC’s”) parent has audited financial statements, the CFC should be able to rely on the parent’s
audited financial statements to avail itself of this rule, even in situations in which
the CFC does not itself have separately audited financial statements.

3. Debt Related Issues

a. The Committee supports the proposal to determine the issue price of debt deemed
to be issued in a modification as the lesser of (1) the adjusted issue price of the
existing debt instrument or (2) the issue price of the modified debt instrument as
would be determined under section 1274\(^1\) if that section applied to the debt
instrument (\textit{i.e.}, as if the debt were not publicly traded). We would clarify that the
proposed rule applies only to significant modifications as defined under current
law (and not to other debt-for-debt exchanges and modifications).

b. The Committee supports the proposal to establish a maximum rate at which
market discount accrues in order to reduce the distortion in taxable income when
a debt instrument is acquired at a deep discount due to the borrower’s financial
distress.

c. We also support the proposal to require all taxpayers to include market discount
(subject to the yield cap) in income as it accrues.

d. The Committee believes that any reform of the interaction between the Code’s
debt and partnership rules should be done in a comprehensive rather than
piecemeal fashion.

e. The Committee suggests that Congress enact a new rule providing that a
taxpayer’s loss on the sale or exchange of a debt instrument (including a deemed
exchange upon retirement) be treated as an ordinary expense to the extent such
loss does not exceed the amount of accrued interest, original issue discount and
market discount the taxpayer has included in income over the taxpayer’s holding
period for that debt instrument.

f. The Committee also recommends that the common law doubtful collectability
exception be codified, apply to both issuers and holders, and apply to stated
interest, OID and market discount alike.

4. Mandatory use of weighted average method of cost accounting for securities

a. The Committee split on the desirability of requiring a single method of
determining basis. Some of members of the Committee believe that the existence
of multiple choices gives taxpayers an unwarranted election to minimize or to
continue to postpone the recognition of gain, undermines the simplicity of basis
reporting, and confuses some taxpayers. On the other hand, other members of the
Committee believe taxpayer choice is an appropriate attribute of our income tax
system, which allows taxpayers to plan and minimize their taxes.

\(^1\) References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the
“Code”), unless otherwise indicated.
b. If there is to be a single method of determining basis in sold securities, the Committee believes that FIFO is preferable to average cost for reasons of simplicity and administrability. The Committee believes that the use of the average cost method would raise numerous issues.

c. The majority of the Committee agrees that basis should be determined using an account-by-account methodology, at least for accounts held at different brokers, which is consistent with the simplification and administrability goals.

d. We also suggest modifying the effective date rules to permit taxpayers to determine basis separately for stock acquired before January 1, 2011, and on or after that date (and, for mutual fund shares, before January 1, 2012 and on or after that date). Thus, the transition rule would segregate securities for which brokers have no record of their customers’ basis from those securities for which they do have such record.

5. Changes to the Wash Sale Rules

a. We support the portion of the Discussion Draft that amends the wash sale rule to explicitly provide for its application when substantially identical securities are purchased by related parties (including retirement accounts) during the 61 day wash sale window.

b. An ordering rule should be included as part of such a legislative proposal so that wash sales within each taxpayer’s own account are determined and applied before wash sales occurring due to purchases by related parties.

c. The related party rule set forth in section 267 should be updated to conform with the version set forth in the Discussion Draft by adding references to retirement trusts.
Detailed Comments on Discussion Draft

1. Mark-to-Market Accounting
   
   
   i. Discussion Draft Proposal.

   Under the Discussion Draft, gain or loss from derivatives generally must be reported on an annual basis under a mark-to-market rule.\(^2\) Each derivative held by a taxpayer is treated as if it were sold on the last business day of the year for its fair market value, and any resulting gain or loss is taken into account for such taxable year.\(^3\) All resulting mark-to-market gain or loss with respect to a derivative is treated as ordinary gain or loss.\(^4\) If a taxpayer holds a derivative contract at the beginning of the taxable year, proper adjustment must be made to any gain or loss subsequently realized with respect to such contract to reflect any gain or loss taken into account by such taxpayer in a prior year.\(^5\)

   The mark-to-market rules of the provision, including the treatment of gain or loss as ordinary, also apply to the termination or transfer during the taxable year of a taxpayer’s rights or obligations with respect to a derivative by offsetting, by taking or making delivery, by exercise or being exercised, by assignment or being assigned, by lapse, by expiration, by settlement, or otherwise.\(^6\) Fair market value on such terminations or transfers is determined at the time of the termination or transfer.\(^7\)

   These mark-to-market rules apply to all derivatives held by a taxpayer, notwithstanding that nonrecognition of gain or loss would otherwise result from the application of any other provision of the Code.\(^8\) Adoption of a mark-to-market regime for derivatives requires that the fair market value of a derivative be determined on each relevant date as necessary to include in income for the taxable year any mark-to-market gain or loss associated with the derivative.\(^9\)

   To the extent provided in regulations, if the fair market value of a derivative is not readily ascertainable, then value is determined under the method used by the taxpayer in reports to shareholders, partners, other proprietors, or beneficiaries, or as used for purposes of obtaining credit.\(^10\) To the extent provided in regulations, fair market value is

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\(^3\) Prop. I.R.C. § 485(a)(1).
\(^7\) Prop. I.R.C. § 485(e)(2).
determined without regard to any premium or discount related to the relative size of the
taxpayer’s position to the total available trading units of an instrument.\textsuperscript{11}

Under the Discussion Draft, a derivative is (1) any evidence of an interest in, or
any derivative instrument with respect to, any (a) share of stock in a corporation, (b)
partnership interest or beneficial ownership interest in a partnership or trust, (c) note,
bond, debenture, or other evidence of indebtedness, (d) certain real property, (e) actively
traded commodity, or (f) currency; (2) any notional principal contract; and (3) any
derivative instrument with respect to any interest or instrument described above.\textsuperscript{12} For
this purpose, a derivative instrument includes any option, forward contract, futures
contract, short position, swap, or similar instrument.\textsuperscript{13} A notional principal contract is any
instrument requiring two or more payments at specified intervals calculated by reference
to a specified index upon one or more notional amounts.\textsuperscript{14} So as not to exclude a contract
that merely rolls more than one interim payment or price adjustment into a single contract
payment, the Discussion Draft specifies that an amount shall not fail to be treated as a
“payment” for this purpose merely because the amount is fixed on one date but paid (or
otherwise taken into account) on a different date.\textsuperscript{15}

A specified index is any one or more of (or any combination of) (1) a rate, price,
or amount (whether fixed or variable); (2) an index based on information that is not in the
control of any of the parties to the instrument and not unique to any of the parties’
circumstances; and (3) any other index as regulations may prescribe.\textsuperscript{16} The provision
excludes from the definition of a derivative certain interests or instruments with respect
to real property.\textsuperscript{17} An interest or instrument is not a derivative if it is either (1) with
respect to a tract of real property as defined in section 1237(c), or (2) with respect only
to real property which would be inventory if held directly by the taxpayer.\textsuperscript{18} The Internal
Revenue Service (the “Service”) is directed to prescribe regulations or other guidance
under which multiple tracts of real property may be treated as a single tract of real
property for this purpose if the interest or instrument is of a type designed to facilitate the
acquisition or disposition of such real property.\textsuperscript{19}

The definition of a derivative is intended to be broad. For example, the term
encompasses an option, a forward, or a futures contract with respect to any stock,
partnership interest, or debt regardless of whether the contract or interest (or the
underlying contract or interest) is privately held or publicly traded.\textsuperscript{20} The term includes
such positions as short sales and short securities futures contracts.\textsuperscript{21} In addition, the

\begin{footnotes}
\footnotesize
\item[12] Prop. I.R.C. § 486(a).
\item[14] Prop. I.R.C. § 486(c)(1).
\item[15] Prop. I.R.C. § 486(c)(1).
\item[16] Prop. I.R.C. § 486(c)(2).
\item[17] Prop. I.R.C. § 486(e)(1).
\item[18] Prop. I.R.C. § 486(e)(1).
\item[19] Prop. I.R.C. § 486(e)(2).
\item[20] Prop. I.R.C. § 486(a).
\item[21] Prop. I.R.C. § 486(b).
\end{footnotes}
provision’s definition of a notional principal contract is broader than the definition under current Treasury Regulations. For example, the Discussion Draft’s definition of a specified index includes indices other than those based on objective financial information, such as temperature, precipitation, snowfall, or frost.22

ii. Policy considerations in Mark-to-Market.

The Committee has considered whether it supports the Discussion Draft’s proposal to mark to market virtually every contractual right or obligation that exists with respect to the specified underlying assets. We have concluded that there are both advantages and disadvantages to such a proposal, as more fully discussed in the subsequent paragraphs. In this part, we discuss these advantages and disadvantages from the policy, constitutional, and administrative perspectives. Where appropriate, we also point out where the mark-to-market proposal would have a differential impact on different types of taxpayers.

From a policy perspective, mark-to-market has the perceived advantage of accuracy of the taxation of income under the Haig-Simons definition of income. That is, the income of a taxpayer in a theoretical sense could be considered to be reflected by net positive cash flows during a measuring period plus an increase in the taxpayer’s net worth, measured on a fair market value basis. If this is the measuring rod, a mark-to-market system of measurement by definition reflects income more accurately than a realization-based system.23 It is not clear, however, that the taxation of unrealized gain comports with the common understanding of an accretion to wealth. Rather, many investors would not consider themselves to be meaningfully wealthier in the absence of a realization event, because in the absence of such an event, any gains continue to be subject to the risk of the market and may be reversed in later periods.24 These arguments would also apply, of course, to all assets, not just derivatives. However, the Discussion Draft does not propose to apply a mark-to-market regime to other types of assets, and we therefore do not discuss the advantages and disadvantages of mark-to-market in that context.

The perception that gains should not be taxed, or losses deducted, in the absence of a realization event is likely to be especially acute among those taxpayers who wind up tax-effecting losses at a lower rate than the rate at which their gains were subject to tax. Suppose, for example, that a taxpayer purchases an option for $50 at the beginning of
year one, and the option appreciates so that it is worth $90 at the end of year one. During
year two, the option lapses unexercised. If the $40 of gain in year one is taxed at a rate
equal to 39.6%, while the offsetting loss is taxed at a rate of only 28% in year two
because the taxpayer is in a lower income tax bracket, the taxpayer will have paid tax at a
rate of 11.6% on gain that turned out to be completely illusory. However, it may be the
case that relatively few taxpayers to whom the mark-to-market proposal would apply,
would ever pay tax at a rate less than the maximum marginal rate in each year, in which
case this potential for over-taxation would be less troubling.

Another perceived policy advantage of mark-to-market taxation is its elimination
of different taxing regimes for different types of instruments. Under current law, options
and forward contracts are taxed on a realization basis, contingent debt instruments are
effectively taxed on an accrual basis, regulated futures contracts are taxed on a mark-to-
market basis, and the regime applicable to notional principal contracts with contingent
non-periodic payments is currently unclear. The character of income from derivatives
also varies depending on the type of instrument involved; periodic payments on notional
principal contracts and interest on contingent payment debt instruments give rise to
ordinary income or deductions, while termination payments on notional principal
contracts and gains from settling forward contracts are capital if the underlying asset
would be a capital asset in the hands of the taxpayer. Uniformity in tax treatment of
different types of derivatives would, all else being equal, constitute a major improvement.

On the other hand, it is not clear that a mark-to-market regime would provide
significant simplification benefits in the cross-border context. In the inbound context, the
main issue (for taxpayers who are not engaged in a trade or business in the United States)
is one of source and treatment as ordinary income (which is generally subject to
withholding tax if U.S. source) or gain (which is generally not so subject). A mark-to-
market regime does nothing to address these issues, because taxpayers would still be
subject to tax under the current regime for fixed or determinable, annual or periodic
gains, profits or income, and any gains or losses resulting from a mark-to-market regime
generally would not enter into the tax system because they would be foreign source. In
the outbound context, the main financial products issues involve foreign exchange issues
and issues relating to the hedging of transactions of controlled foreign corporations,
which the Discussion Draft also does not address.

Additionally, the adoption of a mark-to-market system would create
discontinuities and uncertainties. The discontinuities arise principally from the fact that,
under any politically feasible system of mark-to-market accounting, not all assets will be
marked-to-market. For example, under the Discussion Draft, underlying physical assets,
such as debt (mostly) and stock are not to be marked, while derivatives on those assets

25 It could also happen, of course, that the taxpayer recognizes mark-to-market income in a year in which
his marginal tax rate is relatively low, and a corresponding loss in a year in which his marginal tax rate is
relatively high. In that case, the taxpayer will generate a net tax loss that would not correspond to any
actual economic income loss. This fact pattern seems less likely, however, for the simple reason that mark-
to-market could itself be sufficient to push the taxpayer into a higher tax bracket.

26 To be sure, one could read the reference in the Discussion Draft to “an evidence of an interest in”
stock or debt in Prop. I.R.C. § 485(a)(1).as referring, say, to a brokerage statement reflecting a taxpayer’s
will (generally) be marked.\textsuperscript{27} This paradigm will create both opportunities for tax avoidance and traps for the unwary or poorly-advised, and will, in either case, necessitate the writing of additional rules. Our comments below on the difficulties in formulating the mixed straddle rule in the Discussion Draft reflect the difficulty of policing this boundary; at this point, it is sufficient to note that a mark-to-market rule necessarily creates such fault lines.

The uncertainties inherent in enacting a mark-to-market system arise simply from the enactment of such a major change in the rules governing the taxation of financial products. While the current system, of course, also exhibits numerous uncertainties, practitioners, judges, and the Service do benefit from the hundreds of court cases, regulations and revenue rulings that interpret existing statutes and elaborate on existing doctrines. Thus, to the extent uncertainties exist under a new system (and they will), it is preferable (all else being equal) to maintain an existing uncertainty rather than create a new one.

iii. Constitutional Concerns in Mark-to-Market.

In contemplating moving to a mark-to-market system, constitutional concerns deserve serious consideration. Under Article I, section 9, of the Constitution, Congress does not have the power to impose direct taxes on individuals unless such taxes are apportioned among the states according to population (which is obviously impractical in the context of an income tax). The Sixteenth Amendment to the Constitution provides Congress with the “power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.” In \textit{Eisner v. Macomber} \textsuperscript{28}, the Supreme Court held that stock dividends are not “income” within the meaning of the Sixteenth Amendment because they had not been realized. That is, nothing had been set apart from the corporation and made available to the stockholder for his own use. Accordingly, the stock dividends could not be taxed without apportionment among the states (which of course the statutory scheme did not provide for). The Court’s reasoning would appear to apply with equal force to unrecognized gains, and would perhaps even be stronger than in the case of stock dividends. Thus, if \textit{Eisner} were the only relevant authority, it is likely that a mark-to-market rule would be found unconstitutional. However, courts rejected, on various grounds, every later claim that the Sixteenth Amendment did not encompass within the term “income” the amounts that the Service sought to collect.

\footnotesize{ownership interest in a share of stock or a bond. It is clear, however, that the Discussion Draft does not intend to require the marking to market of a direct ownership interest in stock or debt.}

\footnotesize{\textsuperscript{27} Prop. I.R.C. § 485(a). We use the term “generally” because there are a number of types of instruments that can be made to resemble derivatives, but that the Discussion Draft would not require to be marked-to-market. Such instruments include variable annuities, tracking stock, and partnership interests that track an equity index. We agree with the Discussion Draft’s decision not to include these items within the definition of derivatives because of the line drawing issues that inclusion would create. However, this approach also necessarily means that some derivative-type instruments would lie outside even the broadest practicable mark-to-market system.}

\footnotesize{\textsuperscript{28} 252 U.S. 189 (1920).}
Most relevantly, in *Murphy v. United States*, the taxpayer challenged the requirement under section 1256 to mark regulated futures contracts to market. The requirement was upheld, however, on the grounds that the system of marking such contracts to market for regulatory purposes, and crediting the taxpayer’s futures account for any gains or losses on a daily basis, was sufficient to permit the mark-to-market gains to be treated as income under the Sixteenth Amendment. Such a rationale would not, of course, apply to the majority of assets that would be subject to mark-to-market under the Discussion Draft, because in most cases, there is no crediting of the taxpayer’s account for mark-to-market gain.

While not involving a mark-to-market system of taxation, other courts, too, have rejected the argument that particular amounts were not income within the meaning of the Sixteenth Amendment. Thus, *Helvering v. Horst* dealt with a taxpayer who assigned interest coupons on a bond to his son, intending for his son to be taxable on the interest when it was paid. The Service argued that the taxpayer, not his son, had received the income, and the taxpayer defended in part by relying on *Eisner*, arguing that Congress could not constitutionally tax him in the absence of realization. The Supreme Court held that the realization requirement is “founded on administrative convenience,” rather than constitutional law, and ruled in favor of the government, although without citing *Eisner*. However, *Horst* also can be read as treating the gift of the coupons as itself constituting a realization event, unlike in *Eisner*, where the taxpayer did not do anything other than accept the stock dividend.

After *Horst* came a number of cases that dealt with the power of Congress to require U.S. shareholders of foreign corporations to pay income taxes on their pro rata share of the foreign corporation’s earnings. Thus, in *Eder v. Commissioner*, the Second Circuit considered the tax on foreign personal holding companies in the context of a Colombian company. Notwithstanding that the Colombian peso was subject to currency restrictions and was thus of very limited use to the taxpayers outside of Colombia, the court still upheld the application of the tax, rejecting the constitutional argument in a single sentence without citing *Eisner v. Macomber*.

A later generation of cases reached analogous results regarding the Subpart F regime. As explained most clearly by Judge Tanenbaum in *Estate of Whitlock v. Commissioner*, the rationale for these cases largely turned on Congress’s ability to treat the shareholders of the foreign corporation as receiving the income directly. Such a rationale would not be applicable in the mark-to-market context, where the measure of income results from a change in market prices rather than the receipt of income by a corporation or other entity in which the taxpayer holds an ownership interest.

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29. 992 F.2d 929 (9th Cir. 1993).
30. 311 U.S. 112 (1940).
31. 138 F.2d 27, 28-29 (2d Cir. 1943).
32. 59 T.C. 540 (1972).
33. See also *Garlock Inc. v. Commissioner*, 489 F.2d 197, 200-201 (2d Cir. 1973) (upholding tax on shareholder’s share of current but undistributed earnings of controlled foreign corporation; “the argument that Section 951 . . . is unconstitutional we think borders on the frivolous in light of this court’s decision in *Eder v. Commissioner*. . . .”).
In summary, in addition to the large amount of authority that either distinguished or ignored *Eisner v. Macomber*, that case could potentially be distinguishable from the Discussion Draft on the grounds that it involved two separate legal persons (the shareholder and the corporation), rather than a single taxpayer. Thus, the Supreme Court used the phrase “set apart for [the taxpayer’s] use,” presumably to distinguish funds that still belonged to the corporation versus those that now belonged, following a constitutionally cognizable distribution, to the taxpayer. Obviously, in a case involving the constitutionality of a mark-to-market system of taxation, there is only a single taxpayer, and so this constraint would not apply. (The foreign corporations in the foreign personal holding company and Subpart F cases discussed above were not subject to U.S. income taxes, and thus would also fall on the opposite side of the line from *Eisner v. Macomber*, which may help to explain the pro-government result in those cases.)

Apart from the doctrinal issues, courts tend to be reluctant to hold federal tax legislation unconstitutional, and we think they would be especially so in this case for at least two reasons. First, because it is clear that Congress does have the power to impose direct taxes, a conclusion that mark-to-market is outside the scope of the Sixteenth Amendment would have to be grounded on the importance of the apportionment requirement. From the modern perspective, there appears to be little interest, even among constitutional originalists, in vigorously enforcing the apportionment requirement, which now seems to be antiquated.\(^{34}\)

Second, a conclusion that the realization requirement was constitutionally required would cast at least some degree of doubt on the constitutionality of section 475(a), which requires dealers in securities to mark to market their transactions in securities for tax purposes, because it is difficult to see how the dealers who are subject to that section can meaningfully be distinguished from the broader class of taxpayers who would be subject to mark-to-market accounting under the Discussion Draft.\(^{35}\) Given that section 475 has existed in the Code for twenty years without apparent challenge, we think a court would be reluctant to adopt a rationale with respect to tax realization requirement that would cast doubt on tax constitutionality of section 475.\(^{36}\)

\(^{34}\) At least one commenter has argued that the Founders expected direct taxes to be employed and that apportionment was merely a holdover from the Articles of Confederation period, in which Congress had no taxing power at all. See Calvin H. Johnson, *Apportionment of Direct Taxes: The Foul-Up in the Core of the Constitution*, 7 William and Mary Bill of Rights Journal 1 (1998). Indeed, Professor Ackerman has argued that the Thirteenth Amendment effectively repealed the apportionment requirement. Bruce Ackerman, *Taxation and the Constitution*, 99 Colum. L. Rev. 1, 28, 58 (1999) (“Given the Reconstructionist Amendments, there is no longer a constitutional point in enforcing a lapsed bargain with the slave power.”).

\(^{35}\) Arguably, a securities dealer that is required to mark its securities to market for regulatory purposes faces a lesser burden from a tax mark-to-market rule than a taxpayer that is not so required. However, the scope of section 475 is not limited to securities dealers that are required to mark their securities to market for regulatory purposes.

\(^{36}\) Most commenters have concluded that the realization requirement is not constitutionally required. See Marvin A. Chirelstein, *Federal Income Taxation* 71 (7th ed. 1994) (“[R]ealization is strictly an administrative rule and not a constitutional, much less an economic, requirement of ‘income.’”); Joseph T. Sneed, *The Configurations of Gross Income* 65-72 (1967) (discussing “the Court’s erosion of the constitutional requirement of realization”); Boris I. Bittker, *Charitable Gifts of Income and the Internal*
Administrative Concerns in a Mark-to-Market System

From an administrative perspective, a mark-to-market regime suffers from the obvious concern about valuation. Any mark-to-market system will require the taxpayer to determine, and the Service to either accept or challenge, the value of what may be a highly illiquid asset. Of course, many taxpayers prepare audited financial statements that reflect the mark-to-market values and use those financial statements for significant business purposes. Such taxpayers will have little incentive to understated the value of the derivatives whose fair market values are reflected on their financial accounting balance sheet. Even in this case, however, the Service has not always acquiesced in taxpayers’ reported values, and extensive litigation has sometimes resulted.

In the case of taxpayers who lack financial statements (e.g., individuals), it is likely that more valuation disputes would result. In theory, it is possible for the Service to adopt administrative guidelines that have the effect of permitting taxpayers to choose from among reasonable valuation methods, consistently applied, on the theory that even a rough justice mark-to-market system would be more accurate than the current system. In addition, any valuation inaccuracies would reflect only timing differences, which, given the short-term nature of most derivatives, are likely to be resolved in a relatively short period of time. However, as the litigation referred to above under section 475 suggests, the Service has been reluctant to take such an approach under current law, and the Discussion Draft therefore should be revised to encourage the Service to do so, or at least provide it with explicit authority to adopt such administrative guidelines. As discussed in more detail below, the difficulty that taxpayers and the Service would have in valuing derivatives is greatly exacerbated by the fact that the Discussion Draft requires marking of non-traded assets.

From the taxpayer’s perspective, another practical concern would be obtaining the funds necessary to pay the tax due under a mark-to-market system. An appreciated

Revenue Code: Another View, 65 Harv. L. Rev. 1375, 1380 (1952) (expressing “no doubt” that realization is not constitutionally required); Richard B. Stone, Back to Fundamentals: Another Version of the Stock Dividend Saga, 79 Colum. L. Rev. 898, 916-18 (1979) (realization is an issue of policy, not constitutional law); Stanley S. Surrey, The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions, 35 Ill. L. Rev. 779, 791 (1941) (most commentators agree that realization is not constitutionally mandated); see also Noel B. Cunningham and Deborah H. Schenk, Taxation Without Realization: A ‘Revolutionary’ Approach to Ownership, 47 Tax L. Rev. 725, 741 and n.69 (1992) (citing both judicial and academic authority for the proposition that realization requirement is not constitutionally mandated). Not everyone agrees, however. See Henry Ordomer, Revisiting Realization: Accretion Taxation, the Constitution, Macomber and Mark-to-Market, 13 Va. Tax Rev. 1 (1993) (arguing on the basis of Macomber that mark-to-market taxation would be unconstitutional).

37 Consider, for example, the Bank One case, in which the Tax Court decided a set of valuation issues under section 475, Bank One Corporation. v. Commissioner, 120 T.C. 174 (2003). The taxpayer appealed to the Seventh Circuit, which affirmed in part but vacated and remanded in part under the name JP Morgan Chase and Co. v. Commissioner, 458 F.3d 564 (7th Cir. 2006). The Tax Court tried again, and again the taxpayer appealed, but this time the Court of Appeals affirmed. JP Morgan Chase and Co. v. Commissioner, 530 F.3d 634 (7th Cir. 2008).

38 Prop. I.R.C. § 485(e).
financial position does not itself provide any funds to pay tax, and forcing a taxpayer to liquidate the appreciated asset, or a portion of the appreciated asset, in order to pay the tax due on the appreciation would mean that the mark-to-market system could create substantial distortions in taxpayers’ economic behavior. Such distortions are generally thought to be undesirable from a tax policy perspective.

A taxpayer may be able to borrow against an appreciated asset in order to obtain funds to pay the tax due under a mark-to-market system. Such borrowing would likely come at a cost, however. First, of course, the taxpayer would be required to pay interest, and would perhaps incur other fees, on the borrowing. Second, if the appreciated position is to be pledged as collateral for the borrowing, the lender may well want the taxpayer to enter into a hedging transaction, such as purchasing a put option on the asset, and to pledge its interest in such hedge position to the lender as collateral. In this case, again, the taxpayer would be required to change its economic position and incur additional expenses in connection with the raising of cash to pay the tax on the mark-to-market gain.39

Of course, there is a limit to the degree to which the tax system takes into account lack of liquidity in determining the time to pay tax. A withholding agent who makes a payment of income in kind that is subject to withholding tax is required to make arrangements for the payment of the withholding tax to the U.S. Treasury in cash.40 Similarly, a taxpayer who exchanges appreciated property for other property generally is required to recognize gain at the time of the exchange, notwithstanding that the property received in the exchange may be illiquid.41 While these taxpayers arguably have taken steps to limit their own liquidity (e.g., by exchanging an asset for an illiquid one in a taxable exchange), a taxpayer who entered into a derivative arguably did much the same thing by entering into a derivative transaction that the Code required be marked-to-market. Thus, while the liquidity issue should not be lightly dismissed, neither should it necessarily prevent a mark-to-market system from being adopted.


39 One possibility to allay taxpayers’ concerns here would be to require gains and losses on specified derivatives to be marked to market, but then require the resulting income or deduction to be included in the taxpayer’s income ratably over a defined period of time (e.g., the year of the mark and the five following years). Such an approach would preserve the uniformity sought to be achieved by the Discussion Draft, while lessening the perception that taxpayers were being taxed on amounts that were not yet really income, and while also lessening the need of taxpayers to liquidate investment assets to pay the tax due under a mark-to-market system. On the other hand, use of a mark-and-spread system would be more complicated for both the Service and taxpayers to administer. We would be pleased to discuss this possibility, or to provide additional written comments, if so desired.

40 Reg. § 1.1441-3(e)(1) (“The amount of a payment made in a medium other than U.S. dollars is measured by the fair market value of the property or services provided in lieu of U.S. dollars. The withholding agent may liquidate the property prior to payment in order to withhold the required amount of tax under Section 1441 or obtain payment of the tax from an alternative source. However, the obligation to withhold under Section 1441 is not deferred even if no alternative source can be located.”)

41 Section 1001(c) (except as otherwise provided, the entire amount of gain or loss on a sale or exchange of property must be recognized).
We believe there are both advantages and disadvantages to adopting a mark-to-market system along the lines of the Discussion Draft. However, we believe that if Congress adopts such a system, its structure should be informed by the policy and administrative concerns we have outlined above. The remainder of this report proceeds on the assumption that Congress decides to adopt such a system, and considers what parameters it should possess.

b. Limitation to Derivatives With Actively Traded Underlying Assets

We believe that the scope of the mark-to-market rule should be limited to derivatives in which either the underlying or the derivative or both are actively traded, or with respect to which the taxpayer is required to use mark-to-market accounting for financial reporting purposes. For this purpose, the “actively traded” requirement would be satisfied if the derivative related either to property that is actively traded or to an index with respect to which contracts based on the same or substantially similar specified indices are actively traded.42 We recommend this approach for several reasons, as discussed in the following paragraphs.

First, while valuation issues can be troublesome with respect to non-traded derivatives on actively traded underlying assets or indices – simply because there is no readily available reference price – the valuation issues are even more difficult in the case of non-traded derivatives where the underlying asset or index is not actively traded.43 The illiquidity of the underlying asset frequently reflects a commercial reality that the transaction needs to run its course for a number of years before the profitability of the investment can be determined with an acceptable degree of accuracy. Trying to value such positions on an annual basis makes little sense and may well result in valuation swings back and forth in successive tax returns.

Even if a reasonably accurate value can be obtained for a non-traded underlying asset, a derivative, such as an option or a so-called “kinky” forward contract, that does not increase in value in constant proportion to the increase in the underlying asset (i.e., a non-delta one derivative) cannot be effectively valued using the models and tools normally applied in the marketplace (e.g., the Black-Scholes model) without taking into account the volatility of the underlying asset. Such volatility is very difficult to obtain or even estimate if the underlying asset is not traded. For another example, suppose the holder of a partnership interest in a private real estate partnership grants an option to another investor to purchase that partnership interest. Under the Discussion Draft, such an

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42  See, e.g., Reg. § 1.1092(d)-1(a) (defining actively traded personal property to include any personal property for which there is an established financial market, as defined in Reg. § 1.1092(d)-1(b)).
43  Thus, for example, in the mid-1990s, the Service entered into a contract with the Los Alamos National Laboratory under which the Los Alamos scientists (including quantum physicists and mathematicians) were to develop in the form of software a sophisticated model to assist the Commissioner in valuing interest rate swaps, currency swaps, and other financial derivative products for which mark-to-market reporting was required under section 475. The project proved to be much costlier and more time consuming than the Service had anticipated, and it was suspended (apparently permanently) in 1997. See Bank One Corp. v. Commissioner, 120 T.C. 174 (2003), for a more complete discussion of the scope of the project and the reasons for its suspension.
option would constitute a derivative and therefore would be required to be marked. In the absence of a financial market to provide a consensus view as to the value of such a derivative, the best available valuation methodology would involve modeling the future cash flows projected to be resolved with respect to tax derivative under various assumptions. Thus, in the case of a non-traded derivative with respect to a non-traded underlying asset, a mark to market method of accounting effectively would be replaced by a mark to model method. One would naturally expect in such situations that the values determined under a mark to model methodology would vary considerably.

In short, requiring taxpayers to expend resources to make mere educated guesses at the value of a position does not seem like a desirable attribute of a tax system. If such positions are required to be marked to market, it seems reasonable to expect a substantial number of controversies to arise between taxpayers and the Service.

To be sure, the tax system does require highly illiquid assets, and even derivatives based on those assets, to be valued in a variety of different situations. Thus, for purposes of determining a taxpayer’s charitable deduction, the fair market value of property contributed to a charity must be determined at the time of the contribution. Similarly, in the case of the estate tax, all property in the decedent’s estate generally must be valued at a specified point in time, regardless of how liquid such property is. In those two scenarios, however, the tax system has no choice but to value the property at the specified times because the property is leaving the taxpayer’s possession; if a mark-to-market system for derivatives is not adopted, the property can continue to be subject to tax on a realization basis in the hands of the applicable taxpayer.

Second, the liquidity issue raised above is also likely to pose more problems for a taxpayer in the case of an option on an illiquid underlying asset, such as the real estate partnership described above, than in the case of an option on a publicly traded stock. If a taxpayer is required to borrow funds against the value of an asset to pay the tax on the mark-to-market gain on such asset, it will likely be easier for a taxpayer to persuade a lender to lend against such value if a ready market exists for the underlying asset.

Third, limiting the mark-to-market rule to actively traded derivatives and derivatives for which the underlying asset is actively traded substantially furthers the goal of certainty in the tax treatment of common business transactions and avoids traps for the unwary. As currently drafted, the definition of a derivative encompasses nearly every type of contractual right with respect to one of the listed asset types other than direct ownership. This sweeping approach to defining a “derivative” is appropriate; one of the major positive aspects of the Discussion Draft is that it greatly reduces the number of so-called “cubbyholes” into which a derivative contract must fit under current law (or to which it must be analogized) in order for the tax treatment of such contract to be determined. However, one of the disadvantages of such an approach is that, if the

45 Reg. § 1.170A-1(c)(1).
46 I.R.C. § 2031(a).
47 Prop. I.R.C. § 486(a).
underlying asset is one of those listed in proposed section 485 (e.g., stock or a partnership interest), almost any contractual right with respect to such asset will constitute a derivative and will be required to be marked to market unless an exception can be found (e.g., the hedging exception).\textsuperscript{48} For example, all of the following contractual rights would be required to be marked to market under the Discussion Draft as it currently stands:

1. An agreement by a corporation to sell all of the stock of its subsidiary to another corporation for a fixed or formulary price;
2. An agreement between two partners in a partnership to provide for a buy-sell right with respect to their partnership interests if the partners choose to go their separate ways;\textsuperscript{49}
3. Excess mortgage servicing rights with respect to a pool of residential mortgages;
4. A contract by one corporation to purchase from another corporation all of a given commodity that the first corporation requires in its business;
5. An interest rate lock entered into by an individual (e.g., on a home mortgage);
6. Tax-exempt bonds issued in a revenue bond financing backed by a pledge of a finance lease treated as debt.\textsuperscript{50}

While it may be possible to create a list of exceptions to the general rule requiring the marking to market of all derivatives, we would counsel against it. As long as the general rule requires marking of non-traded derivatives on non-traded underlying assets, any list of exceptions would necessarily be incomplete. Furthermore, the existence of such a list, by removing from the mark-to-market regime the more common transactions, might blind taxpayers or the IRS to the necessity of marking to market other transactions that are not on the list of carve outs. This would create the potential for unintended benefits or detriments to taxpayers.

Given the valuation and liquidity problems associated with marking to market all of these contracts, we recommend limiting the scope of the mark-to-market rule to actively traded derivatives and derivatives with respect to an actively traded asset or index.\textsuperscript{51}

\textsuperscript{48} Prop. I.R.C. § 486(f).
\textsuperscript{49} If the agreement provides a mechanism for the partners to reach agreement on the fair market value of the partnership interest being sold, and requires the interest to be bought or sold at that price, then the value of the agreement may not change very much as the partnership interest increases or decreases in value. Nevertheless, economic theory suggests that merely entering into the agreement would have a positive value to both partners because of the increased liquidity and decreased uncertainty that the agreement provides. Otherwise, the partners would not enter into the agreement. Under the Discussion Draft, this positive value would have to be taken into account by both partners as income based on the value of the agreement on the last business day of the taxable year in which the agreement was entered into. We believe that this result is inappropriate.
\textsuperscript{50} Prop. I.R.C. § 486(a).
\textsuperscript{51} As an aside, if Congress does not adopt a mark-to-market regime for derivatives generally, we respectfully suggest that Congress expand the existing elective mark-to-market regime under section 475(f). Currently, the mark-to-market regime is available only to those who qualify as traders in securities under applicable case law. Many investors would not choose to make the election even if the law were
c. Derivatives embedded in debt.

Under the Discussion Draft, the mark-to-market rule generally applies to any embedded derivative component of a debt instrument, but only to such derivative component. Thus, if a debt instrument has an embedded derivative component, it generally is treated as two separate instruments—a derivative that is subject to the mark-to-market rule and a debt instrument that is not. The fair market value of the embedded derivative component equals the excess of (A) the fair market value of the debt instrument including such component, over (B) the fair market value of the debt instrument not including such component. For this purpose, an “embedded derivative component” means any provision of a debt instrument that affects some or all of the cash flows or the value of other payments required by the instrument in a manner similar to a derivative. The Technical Explanation provides that one example of a debt instrument with an embedded derivative component is debt that is convertible into the stock of the issuer. However, the Discussion Draft does not treat a debt instrument as having an embedded derivative component merely because the debt instrument is denominated in or specifies payments by reference to a nonfunctional currency, is a contingent payment debt instrument (“CPDI”) or variable rate debt instrument (“VRDI”), or has an alternative payment schedule.

In evaluating the Discussion Draft’s proposals regarding embedded derivative components, the first issue the Committee considered was the scope of the proposal. The general definition of “embedded derivative component” in the Discussion Draft is quite broad, but the scope is restricted by the carve-outs for nonfunctional currency-denominated debt, CPDIs, VRDIs, and debt instruments with alternative payment schedules. Because most instruments with contingencies would be subject to one of these sets of rules, the embedded derivative rule appears quite limited in its operation. We understand, based on informal discussion with Ways and Means Committee staff, that the provision was intended to apply mainly, if not exclusively, to convertible debt instruments that do not fall within the contingent payment debt instrument rules.

We believe that many difficulties would arise under a regime that requires an embedded derivative component to be bifurcated from a debt instrument and separately marked to market. Unlike the more generally applicable mark-to-market regime, such a bifurcate-and-mark concept is not currently used anywhere in the Code, and employing it changed to allow them to do so (because, by doing so, they would forfeit the possibility of getting long-term capital gain rates). However, there is no policy reason to deny investors the right to make the election if they wish to do so, and such change would also reduce the (fairly considerable) amount of time that taxpayers, advisors, and the Service currently spend to determine whether a particular taxpayer qualifies as a trader under the applicable case law.

54 Prop. I.R.C. § 485(e)(3).
would raise novel issues. For example, consider a debt instrument that is convertible into stock of the issuer, but that also gives the issuer the right to call the instrument under certain circumstances. The instrument provides that the exercise of the call right permits the holders to convert the instrument immediately into stock (even if they otherwise were not allowed to do so), but also has the effect of forcing conversion immediately if the conversion option is in the money (i.e., because otherwise the holder would lose the value of the call option). The Discussion Draft would require the hypothetical stand-alone debt instrument to be valued. In doing so, should the call feature be treated as part of the hypothetical stand-alone debt instrument (in which case its value would not enter into the mark-to-market valuation of the embedded derivative) or part of the embedded derivative (in which case its value would so enter)? While specific rules could be written to deal with this problem, the larger point remains: the tax law would be forcing the bifurcation of an instrument that is legally and economically a single integrated unit, which would raise valuation issues. Given the intractability of this issue and the desire to achieve uniformity among different types of derivatives, we would recommend against the adoption of the “embedded derivative” rules set forth in the Discussion Draft.

Given that recommendation, we next considered whether to recommend that all debt instruments containing embedded derivatives be marked to market in their entirety. Doing so would certainly contribute to simplification and to the similar treatment of similar products. However, existing rules are generally perceived to be working well for certain instruments, such as a debt instrument with a fixed rate or a LIBOR-based floating rate, and it seems too radical a departure from past practice to require such plain vanilla instruments to be marked to market. However, marking some debt instruments while not marking others would require drawing a line between, for example, debt instruments that are now subject to the CPDI rules and those subject to the VRDI or alternative payment schedule rules. Because the dividing lines between the various sets of debt taxation rules are somewhat arbitrary, drawing such distinctions under a mark-to-market regime would likely result in dissimilar treatment of economically similar derivatives. For example, a debt instrument that provided its holder with a 60% probability of an 8% return and a 40% probability of a 6% return would be subject to the CPDI rules (and would therefore not be marked under the Discussion Draft’s proposal), while a debt instrument that provided its holder with a 70% probability of an 8% return and a 30% probability of a 6% return would be subject to the alternative payment schedule rules (and therefore would be marked under such proposal). Thus, a rule requiring some but not all debt instruments to be marked to market does not appear to us to be justified.

Having reached this conclusion, we are of the view that debt instruments, including those with an embedded derivative component, should be outside the mark-to-

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58 Indeed, the bifurcation of a unitary instrument is itself fairly uncommon, even when neither of the components is marked to market. Compare Reg. § 1.1275-4(b) (no bifurcation of contingent payment debt instruments) with former Prop. Reg. § 1.1275-4(g) (requiring certain types of contingent payment debt instruments to be bifurcated with the tax accounting principles appropriate to each component applied on a standalone basis).

market regime contemplated by the Discussion Draft. Instead, such instruments (including noncontingent convertible debt instruments) should be subject to the existing CPDI, VRDI, and alternative payment schedule rules. This approach is, of course, consistent with the treatment of such instruments under the Discussion Draft (except in the case of noncontingent convertible debt instruments, which are marked-to-market under the Discussion Draft).

To be sure, a regime that marks free-standing derivatives to market without also marking the embedded derivative component of a debt instrument will require a determination of whether a particular instrument provides enough principal protection to constitute a debt instrument and, therefore, avoid being marked. However, as noted above, such a determination would also be required under the Discussion Draft. In particular, if an instrument were debt, only the embedded derivative component would be marked under the Discussion Draft, while if it were not debt (e.g., if it were a prepaid forward contract), then the whole instrument would be required to be marked. Additionally, the determination of whether an instrument has sufficient principal protection to constitute debt (as opposed to constituting a non-debt derivative) must be made under current law, and practitioners are therefore familiar with the parameters of this distinction. On balance, we believe that excluding all debt instruments from the mark-to-market regime best carries out the policies underlying the Discussion Draft.

d. Treatment of certain positions as derivatives.

We have also considered the appropriateness of the Discussion Draft’s treatment of certain positions or transactions as derivatives, and therefore subject to marking to market.

One such position is a short position with respect to an underlying asset. When practitioners speak of a short position, they generally refer to a transaction in which a taxpayer borrows from a broker a unit of fungible traded property (e.g., a share of stock) and then sells that asset in the market, hoping to profit from a decline in the price by buying it back at a lower price. Current law applies open transaction treatment to the opening of a short sale and treats the closing of a short sale as the time for recognizing gain or loss (generally capital) on the transaction. However, there is no policy reason why this rule must apply. The concept of capital gains and losses, it is believed, developed to prevent a taxpayer from selling loss assets and using such loss against its business income, while deferring the recognition of gains by not selling gain assets. As a practical matter, an uncovered short position generally reflects a relatively short term view of the markets. Indeed, a short position with respect to debt must be closed out, and all gain or loss recognized, before the debt instrument matures. Thus, gain on a short position cannot be deferred for lengthy periods of time without recognition, and it is not unreasonable to treat a short position as producing ordinary income.

We would, however, note that many hedge funds hedge appreciated derivatives with short positions in equity. Treating a short position in equity as a transaction within the mark-to-market regime will greatly broaden the applicability of the mixed straddle
regime, which we discuss below. While such broadening is not intrinsically undesirable, it does increase the stakes inherent in that regime, and therefore make it particularly important that the mixed straddle regime be neither too harsh nor too lenient.

Finally, we note that a mark-to-market regime for short positions raises an issue as to the treatment of foreign currency denominated borrowings. In the past, Congress has observed that a foreign currency borrowing is economically similar to a short position in the foreign currency.\(^60\) This creates an obvious asymmetry issue if a transaction denominated as a short sale in a foreign currency receives mark-to-market treatment, while an economically similar transaction denominated as a foreign currency borrowing is taxed on an accrual basis. One obvious solution to this problem is to exclude short positions in foreign currency from the mark-to-market rules entirely, thereby harmonize the treatment of such positions with transactions that are denominated as foreign currency denominated loans. Such a solution would, however, create a disparity in tax treatment between the treatment of nonfunctional currency denominated debt issued by the taxpayer (which would not be marked-to-market) and the treatment of nonfunctional currency denominated debt issued by a third party that the taxpayer then sells short (which would be marked-to-market). Consequently, it may be advisable to also exclude short positions in third party nonfunctional currency denominated debt from the mark-to-market rules.

In contrast with short transactions (other than with respect to foreign currency), we believe that securities lending transactions should not be marked-to-market. While it is not clear from the Discussion Draft whether the draft statutory language is intended to require the lender’s position in a securities loan to be marked-to-market, we believe that the statutory language as currently drafted has that effect where the lent security falls within the category of underlying property set forth in the statute (e.g., stock or debt).\(^61\) The draft statutory language includes within the definition of a derivative “an interest in” one of the enumerated types of property, and it appears that the right of the security lender to receive back stock or debt identical to that lent constitutes an “interest in” the stock or debt.\(^62\) (Of course, it could also be argued that a simple ownership interest in stock would also meet this requirement, but that was clearly not the intent of the Discussion Draft.)

We believe that mark-to-market treatment is generally not appropriate for a securities lending transaction, because such transactions are entered into primarily to permit the borrower (or its customer) to short the borrowed security while preserving the lender’s economic exposure. Given that the transaction is, from the lender’s perspective, merely a substitute for continuing to hold the security, coupled with a small borrow fee, it seems reasonable to treat it in the same manner as continuing to hold the security would be treated. Additionally, treating a securities lending position as a derivative would create an even sharper disparity than exists under current law between a repo transaction, in which the repo seller continues to be treated as the owner of the security for tax purposes,

\(^{61}\) Prop. I.R.C. § 486(a).
\(^{62}\) Prop. I.R.C. § 486(a).
and a securities lending transaction, in which the lender is not treated as the owner. Increasing such a disparity would be antithetical to the intent of the Discussion Draft, as discussed above.

Lastly, we note that the Discussion Draft raises issues regarding the continued application of section 1032 to options issued by a corporation with respect to its own stock. Under current law, section 1032 provides in pertinent part that “[n]o gain or loss shall be recognized by a corporation with respect to any lapse or acquisition of an option, or with respect to a securities futures contract . . . to buy or sell its stock (including treasury stock).”

While the Discussion Draft does not specifically provide that the mark-to-market rule is intended to override section 1032, the Technical Explanation to the Discussion Draft describes the scope of the mark-to-market rule by noting that the rule applies notwithstanding any non-recognition provision, which certainly seems broad enough to override section 1032. While the scope of section 1032 is uncertain under current law, and reform is certainly needed in this area, we respectfully suggest that the Committee specifically exclude section 1032 issuances from the mark-to-market regime. The mark-to-market system deals with the character and timing of items that will assuredly be income at some point in time. By contrast, section 1032 deals with the question of whether an item (e.g., gain or loss realized by the corporate taxpayer with regard to a derivative on its own stock) is to be treated as income at all. The policy concerns here (particularly, anti-whipsaw issues) are fairly difficult to resolve, and we believe it is not necessary to resolve these issues in order to achieve the Discussion Draft’s goal of reforming the system of taxing financial products.

e. Treatment of Mixed Straddles.

By far the most difficult technical aspect of the mark-to-market regime proposed by the Discussion Draft involves the interface between the mark-to-market and realization regimes. The Discussion Draft provides that the mark-to-market and ordinary treatment rules apply to all positions in a straddle that includes any derivative to which the provision applies, even if these positions are not otherwise marked to market (i.e., a mixed straddle). In addition, special rules apply to positions not otherwise marked-to-market that become part of a mixed straddle. If the position has a built-in gain, the position is treated as sold for its fair market value at the time of entering the mixed straddle. Proper adjustment must be made to any gain or loss subsequently realized with respect to such contract to reflect any gain taken into account by such taxpayer by reason of the deemed sale. If the position has a built-in loss, the position is not treated as sold at the time of entering the mixed straddle and the amount of the built-in loss is not taken

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63 I.R.C § 1032(a).
65 Prop. I.R.C. § 485(c)(1).
into account in determining the amount that is marked-to-market during the period of the mixed straddle.\(^{68}\) Rather, the amount of the built-in loss is taken into account in determining the amount of gain or loss when the position is disposed of in a transaction in which gain or loss is otherwise recognized.\(^{69}\) The holding period for the position does not include the period during which it is part of a mixed straddle.\(^{70}\) A consequence of the special rules for built-in gains and losses in a non-derivative position that becomes part of a mixed straddle is that the only gain or loss in the non-derivative position that is taken into account under the mark-to-market regime is gain or loss that accrues during the period when the position is part of a mixed straddle. The Discussion Draft’s special rules for the treatment of derivatives do not apply to any derivative that is part of a hedging transaction (as defined in new section 1221(c)).\(^{71}\)

The Committee understands why the Discussion Draft would require that a non-derivative be marked to market if the taxpayer also held an offsetting position with respect to personal property. The drafters presumably believed that, just as under current law for mixed straddles, it would be inappropriate to require a taxpayer to mark a derivative to market and then defer any loss realized on such mark (under section 1092) while recognizing currently any gain. This certainly makes sense to the Committee, but the Committee is concerned that this aspect of the mark-to-market rules would subject a large number of business-oriented, non-tax-motivated transactions to mark-to-market, and that the mark-to-market rules would be difficult to apply in many of these contexts.

Modern businesses use derivatives to manage a wide variety of exposures that include risks with respect to capital assets. As an example, consider a short foreign currency position entered into to hedge a foreign currency denominated loan receivable that is a capital asset in the hands of the creditor. It is not clear that a derivative hedging foreign currency exposure with respect to such a loan receivable can qualify as a section 1221 tax hedge if the receivable is a capital asset, notwithstanding the fact that gain or loss on the receivable attributable to foreign currency fluctuation would be ordinary under current section 988. If such a derivative does not qualify as a hedge, then the derivative, together with the loan receivable, would constitute a straddle. Under proposed section 485, both the derivative and the loan receivable would be marked-to-market under the mixed straddle regime.

Applying a mark-to-market regime to the combination of the foreign currency hedge and the foreign currency denominated loan receivable would create many of the same valuation and liquidity issues discussed above. For example, consider a taxpayer who purchases a debt instrument for €100 (at a time when €1 equals $1) and simultaneously buys a put on €100 for $2. Under the mixed straddle regime outlined in the Discussion Draft, both the put and the foreign currency denominated debt instrument would need to be marked-to-market, which would raise the same valuation and liquidity issues with respect to the debt instrument that we discussed above with respect to

\(^{70}\) Prop. I.R.C. § 485(c)(4).
\(^{71}\) Prop. I.R.C. § 486(f).
derivatives. Of course, if the changes in value of the hedge perfectly offset changes in value of the asset being hedged, then the net mark-to-market gain and loss would be zero. In the business context, however, such perfect offsets are uncommon. In the previous example, for instance, the U.S. multinational wanted to hedge the foreign currency risk embedded in the loan receivable, but did not want to hedge the interest rate risk or credit risk. Suppose the debt appreciates to $105 because the euro appreciates against the dollar, while the put declines to $1. The combination of positions, then, has increased in value by a total of $4. In this case, a perfect offsetting of mark-to-market gains and losses would not occur. Indeed, because the straddle rules require only a substantial diminution of risk, rather than an elimination of risk, one would expect many straddles to result in substantial net mark-to-market gain or loss.

The Committee discussed a number of potential solutions to these problems, which generally fell within two broad categories. First, one could attempt to expand the definition of a hedging transaction. This would reduce the range of transactions that would subject taxpayers to mixed straddle treatment as contemplated by the Discussion Draft, because hedging transactions are not subject the Discussion Draft’s mark-to-market rules. Second, one could accept that the mixed straddle rules would apply to as wide a range of transactions as contemplated by the Discussion Draft, but could alter the mixed straddle rules contemplated by the Discussion Draft to blunt their impact. We discuss each of these possible solutions in turn.

Expanding the definition of a hedging transaction initially had a great deal of appeal for many members of the Committee. As noted above, there are many transactions that taxpayers consider hedging transactions that do not qualify as hedges for tax purposes. For example, many insurance companies enter into derivative transactions to hedge interest rate or credit risk with respect to their portfolios of debt investments; such derivatives do not qualify as hedges under current law because the asset being hedged will produce capital gain or loss. Similarly, many corporate taxpayers enter into hedges with third parties of foreign currency denominated debt issued by their controlled foreign corporations. In both of these circumstances, as well as others, a rule that allowed these derivatives to be identified as hedges would avoid the volatility in taxable income and large book-tax differences (for taxpayers that do not mark their books to market) that would arise from marking-to-market such derivatives under proposed section 485.

Moreover, if a more expansive definition of a hedge could be implemented, the benefits could extend beyond avoiding the mixed straddle regime. One notable example is the use of foreign currency derivatives by U.S. based companies to hedge their net investments in foreign subsidiaries. Because these are hedges related to a capital asset, they do not qualify as tax hedges, under either current law or the Discussion Draft. Given the volatility of current exchange rates and the large size of many of these hedges, marking such hedges to market under the mixed straddle rule in the Discussion Draft would add considerable volatility to the taxable income of taxpayers entering into such hedges. Allowing such derivatives to be identified as hedges would be consistent with financial accounting treatment of such hedges and would be an improvement over current law.
More ambitiously still, Congress could consider an operative rule to provide greater symmetry between the tax attributes of the gain or loss on the hedge derivative and the gain or loss on the item being hedged. The current hedging rules under section 1221 and Regulation section 1.446-4 only provide symmetry with respect to ordinary character and timing of gains and losses on the derivative and the hedged item. Symmetry across other tax dimensions, such as source, Subpart F character, character as interest income or expense, treatment for depletion purposes, etc. either is not addressed or is addressed in a piecemeal fashion in other regulations. Ideally, a rule could provide that if a taxpayer identifies a derivative as a hedge of a specific item, the gain or loss on the derivative will be characterized for all federal income tax purposes as an adjustment to the income, deduction, gain or loss arising from such item.

Such a rule would eliminate the discontinuities that currently arise because of the narrow operation of the current hedging rules and would provide greater simplicity by eliminating the need for many of the special regulations dealing with hedges in the context of specific Code provisions.

However, the Committee is aware that expanding the hedging regime would also have some drawbacks. First, from a timing perspective, income or deduction from hedges of capital assets may be more difficult to match up with the income from those underlying assets than income or deduction from hedges of ordinary assets or obligations. As a general matter, capital assets tend to be those that a taxpayer holds for longer periods of time and as to which the taxpayer has discretion over the timing of a taxable disposition. This fact tends to increase the difficulty of appropriately matching up the timing of items from the hedge with the timing of items from the hedged position. It also simultaneously increases the importance of making these determinations, because gains or losses from a hedge of a capital asset (e.g., stock in a subsidiary) arguably may be deferred for longer periods. At a minimum, such a method would place great importance on hedging identifications, which is an area that many taxpayers struggle with under the current identification rules.

Another difficulty with a capital asset hedging regime involves the character of gain or loss. Under the currently applicable hedging regime, the matching of character is largely avoided because hedged items can only produce ordinary income or loss. Under a capital asset hedging regime, however, such issues would need to be dealt with because many capital assets can produce ordinary income. One example of this would be the investment in a foreign subsidiary discussed above. A foreign currency derivative, for example, might hedge the value of the stock of such subsidiary, in which case gain or loss on the hedge would properly be considered an adjustment to the stock basis. However, a foreign currency derivative might also be entered into to hedge foreign currency denominated dividends payable on such stock over a period of time, in which case ordinary treatment for the gain or loss on the hedge seems more appropriate.

Another familiar example of a capital asset that can produce ordinary income is a debt instrument. Debt instruments generally are capital assets, but they produce ordinary
income in the form of qualified stated interest, market discount, and original issue
discount. Under an expanded hedging regime, it is not clear under what circumstances
gains and losses from a debt hedge (e.g., an interest rate swap) would be applied to
reduce market discount or increase amortizable bond premium, on the one hand, or to
reduce the amount of capital gain, or increase the amount of capital loss, upon the sale or
retirement of the debt instrument, on the other hand.

These issues would likely become even more difficult if the rules were broadened
as discussed above to include hedges of source, Subpart F income, and other attributes.
This difficulty would arise both because of the multiplicity of fact patterns that would
have to be dealt with and because of the greater importance, at least in some contexts
(e.g., Subpart F) of getting appropriate matching of items from the hedge with items from
the hedged position. Given the complexities of even a relatively simple expanded
hedging model (i.e., one that deals only with capital gains and losses and does not address
the other issues referred to above), the Committee chose in the interest of expediency not
to develop these ideas further. However, we would be pleased to prepare another report
that focuses on these important issues if the Congress would find that helpful.

The Committee also considered whether at least some, but not all, of the problems
of the mixed straddle regime could be addressed by adopting a modified mark-to-market
regime in lieu of a capital asset hedging regime. Under one variation of this regime, in the
case of a mixed straddle, the non-derivative position (e.g., stock) would be marked to
market with any gains or losses being ordinary, but only to the extent of any offsetting
gains or losses on the derivative. For example, if a taxpayer owns stock with a value of
$100 and buys a put for $2, and the stock appreciates to $105 while the put depreciates as
of the end of the taxable year to $1, the taxpayer would recognize $1 of ordinary loss on
the put but would also be required to recognize $1 of ordinary gain on the stock, which
would cause a step-up in the basis of the stock by that amount.

This approach would have two principal advantages over the approach set forth in
the Discussion Draft. First, because the entire gain on the non-derivative position (e.g.,
the stock in the example in the preceding paragraph) would not be have to be recognized,
the taxpayer would not suffer from the illiquidity problem discussed above. Second,
valuation issues would be alleviated under this approach, because it would not be
necessary to perform a full valuation of the non-derivative position. Rather, it would only
be necessary to determine that there was at least as much gain (or loss) in the non-
derivative position as there was loss (or gain) in the derivative position.

Some members of the Committee, however, pointed out that if the stock in the
previous example had declined in value, while the put option had increased in value, the
taxpayer could recognize an ordinary loss on the stock in a circumstance in which the
taxpayer would recognize capital loss if the stock were simply sold. These members
argued that this result was inappropriate, yet it also did not seem appropriate to provide
for ordinary loss treatment on the sale of the stock because the timing of such sale was
entirely within the taxpayer’s control. In the end, the Committee decided not to
recommend this modified mark-to-market proposal, either.
The Committee had an easier time dealing with the issues surrounding the recognition of built-in gain and built-in loss in the context of a mixed straddle. We are sympathetic with what we understand to be the Discussion Draft’s concerns, based on staff comments. For example, if built-in gain were not triggered immediately upon entry into an offsetting position, a taxpayer could enter into a position that constituted nearly a perfect hedge of the gain position, and thus indefinitely defer recognition of the gain. Similarly, if built-in loss were triggered immediately upon entry into an offsetting position, a taxpayer could enter into a position that constituted only a slight reduction in the risk of holding the position, and immediately trigger the loss, while continuing to have full exposure to the opportunities for gain. In our view, however, the asymmetry of the provisions for triggering built-in gain, while deferring built-in loss, will strike many taxpayers as unfair. If entering into a particular derivative, or a combination of derivatives, does not constitute sufficient risk reduction to justify the recognition of loss, then such combination should also not be sufficient to trigger the recognition of gain.

The foregoing principle, however, does not resolve the issue of which rule should be relaxed—the one requiring built-in gain to be recognized or the one precluding the recognition of built-in loss. We believe it is the built-in gain rule that should be relaxed, for several reasons. First, the built in gain or built in loss accrued economically under a realization-based system, and it seems consistent with such accrual for it to continue to be governed by such a system. Second, it would, in many circumstances, be inappropriate as a policy matter to allow loss recognition merely because sufficient risk reduction had been achieved to trigger the straddle rules. For example, if a taxpayer owned depreciated stock and either bought a par put option on such stock or sold a par call option on such stock, loss recognition would seem inappropriate, because the taxpayer would still have all of the upside potential or downside risk, respectively, with respect to such stock. And, based on the principle of symmetry discussed in the preceding paragraph, if the degree of risk reduction is insufficient to justify the recognition of loss, so too should it be insufficient to require the recognition of gain. Third, if the level of risk reduction on an appreciated position reaches a sufficiently high level to justify the recognition of gain as a policy matter, it is likely that section 1259 in its current form would require such recognition. We therefore recommend that the Discussion Draft’s rule requiring recognition of built-in gain on a non-derivative position when an offsetting position is entered into should be eliminated, and instead, the Discussion Draft’s rule for built-in losses should be applied to built-in gains as well.

f. Other Straddle-related Issues Under a Mark-to-Market System.

Whatever the consequences of entering into a mixed straddle, the definition of a mixed straddle in the Discussion Draft includes many combinations of positions that would not be straddles, mixed or otherwise, under current law. Under the Discussion Draft, for purposes of applying the mixed straddle regime, the term ‘straddle’ has the meaning given such term by section 1092(c) applied without regard to section 1092(c)(2)(B) and by treating all offsetting positions as being with respect to personal property. Thus, the definition of a “straddle” for purposes of applying the mixed straddle
rules in the Discussion Draft is enlarged in at least three ways. First, a straddle will be determined without the rules, contained in section 1092(c)(2)(B) ring-fencing identified straddles. Second, the rule limiting a straddle with respect to stock to substantially similar or related property is eliminated. Third, the rule limiting the impact of a qualified covered call on holding period and loss deferral is eliminated. We discuss each of these three changes in turn.

i. Elimination of the Rule for Identified Straddles.

The first rule described above turns off the provision of existing law that any position which is not part of an identified straddle (within the meaning of subsection (a)(2)(B)) will not be treated as offsetting with respect to any position which is part of an identified straddle. The absence of any rule for identified straddles creates the potential for great uncertainty regarding the scope of a straddle in a particular case. For example, consider a taxpayer who purchases 100 shares of stock and simultaneously purchases a put option on 40 of those shares. Given the vagueness of the statutory language (i.e., referring only to a “position” with respect to personal property), there are a number of possibilities. First, the put option might be viewed as substantially diminishing the risk of loss on the entire 100 shares of stock, in which case presumably all 100 shares would need to be marked to market under the Discussion Draft’s proposal. Second, the put option might be viewed as diminishing the risk of loss with respect to less than all, but more than 40, of the 100 shares in the long position. Third, the put option might be viewed as diminishing the risk of loss only with respect to 40 shares of the stock in the long position. Fourth, the entire 100 share stock position could be viewed as reducing the risk of loss on the put option over 40 shares (i.e., because the put option will tend to lose value as the stock price increases, but the stock itself will of course gain value as the stock price increases).

This “one side larger than the other” issue created both uncertainty and potential unfairness to taxpayers prior to the 2004 enactment of the identified straddle regime in its current form. The uncertainty would be more significant under the Discussion Draft’s proposal, because any stock that was part of a straddle would need to be marked to market. Thus a relatively small change in the economics of a transaction (e.g., the purchase of a put option on a single share of stock) could require a 100 share long position to be marked-to-market. This seems inappropriate from a tax policy perspective. Continuing to allow taxpayers to identify some of the shares together with the put option as a straddle would greatly alleviate these problems.

ii. Elimination of Requirement of Substantially Similar or Related Property for Straddles Involving Stock.

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72 While the Discussion Draft’s proposal technically applies only to mixed straddles as defined therein, and not for purposes of applying the straddle rules generally, the mixed straddle regime contemplated by the Discussion Draft would for most purposes displace the remainder of the straddle regime.

Under current law, section 1092(c) defines a straddle as “offsetting positions with respect to personal property.” Positions are offsetting with respect to personal property if there is a substantial diminution of the taxpayer’s risk of loss from holding any position with respect to personal property by reason of his holding one or more other positions with respect to personal property (whether or not it is the same kind). This standard, then, is quite broad, but it is limited because stock is not treated as personal property unless such stock is of a type that is actively traded and at least one of the positions offsetting such stock is a position with respect to such stock or substantially similar or related property. The definition of “substantially similar or related property” is contained in section 246(c), and generally cannot be satisfied unless the other property is a position with respect to the stock itself, including a derivative position. Those regulations make it clear that a short position in an index of stocks that hedges general market risk does not constitute substantially similar or related property with respect to one of the stocks that make up the index.\(^74\) The Discussion Draft overrides this rule, providing that, in determining whether a mixed straddle exists, section 1092(c) is applied by treating all offsetting positions as constituting a straddle. Thus, a taxpayer who held a basket of large capitalization U.S. stocks and diminished his market risk by selling short the S&P 500 index could have a straddle, even though there was no overlap between the stocks in the taxpayer’s long and short positions.\(^75\)

It is not clear whether or not this result was intended, but the Committee recommends that this expansion of the definition of a straddle be eliminated in any future bill. In general, this Committee believes that the realization method (including the possibility of recognizing long-term capital gain) should continue to apply to long non-derivative positions in stock unless it appears that the taxpayer is attempting to manipulate the rules. Hedging a long portfolio to reduce general market risk simply does not, in our view, constitute sufficient evidence of rule manipulation to justify imposing a mark-to-market regime on the taxpayer, and this is particularly true if the leg-in rule referred to above is retained. Moreover, given how common stock portfolios are, and how low and uncertain the standard for “substantial diminution” is, the Service and taxpayers will inevitably consume substantial resources arguing about whether this standard has been met. For example, suppose the taxpayer believes that the stock market will fall if interest rates rise because of tightening by the Federal Reserve, and therefore shorts Treasuries to protect against an interest rate increase. Does this satisfy the substantial diminution test? It might during certain periods of time and under certain market conditions. This Committee, however, does not believe that a taxpayer who engages in such a transaction should be subject to mark-to-market with respect to the related stock portfolio, and certainly does not believe that built-in gain in the stock portfolio should be triggered upon the short sale of the bonds. Lastly, the Committee does not believe that mark-to-market losses on the short position, if any, should be deferred until the recognition of gains on the stock portfolio, which is what the Discussion Draft’s

\(^{74}\) See, e.g., Reg. § 1.246-5(d) (Ex. 1) (stock of one automobile maker not substantially similar or related property with respect to stock of another automobile maker).

\(^{75}\) Compare Reg. § 1.246-5(c)(1) (position with respect to a portfolio of stocks not treated as substantially similar or related property to stocks held by taxpayer unless there is “substantial overlap” between the portfolio and the stocks).
elimination of the “substantially similar or related property” rule would accomplish. Thus, we recommend preserving the historic rule requiring offsetting positions with respect to stock to be include positions with respect to the stock or substantially similar or related property before a straddle can exist.

iii. Deletion of Special Rules for Qualified Covered Calls.

Under current law, the combination of stock and a “qualified covered call option” (in essence, a statutorily-defined option that is either out of the money or not too deeply in the money and that meets certain other requirements that limit its ability to reduce risk on the underlying stock) generally is not subject to the loss deferral and holding period rules of section 1092 or the capitalization rules of section 263(g). The Discussion Draft, however, would delete this exception to the straddle rules, so that covered call options would be subject to the same rules as all other straddles. On balance, the Committee supports this deletion. From an economic perspective, a short call option can be an effective hedge of the risk created by holding a long position in stock. From an administrative perspective, the rules for qualified covered calls are quite complicated and have numerous exceptions and qualifications. The argument originally made in favor of the qualified covered calls rules was that writing call options was a strategy that relatively unsophisticated investors engaged in, and that such investors were not well-equipped to deal with the complexities of the straddle rules. While this argument likely still has some merit, in our judgment, it is outweighed by the economic and administrability concerns described above.

76 Prop. I.R.C. § 1092.
2. Allowing Financial Accounting Hedge Identifications to Qualify as Tax Hedge Identifications

a. Background

Under case law emanating from the *Corn Products v. Commissioner* decision, business hedges generally were treated as giving rise to ordinary, rather than capital, gain or loss. In 1988, however, the U.S. Supreme Court rejected this interpretation of the capital asset rules in *Arkansas Best v. Commissioner*. 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 regulations issued under section 1221 require 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.” 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.”

Under the section 1221 regulations, the improper identification or non-identification of a transaction as a hedge can have meaningful consequences. 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, a loss from a position 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.

The Code also now contains an identification requirement in the section 1221 context. This requirement was added by the Tax Relief Extension Act of 1999, which

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79 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. Reg. § 1.1221-2(d)(5)(i).
81 Reg. § 1.1221-2(g)(2).
82 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 (Reg. § 1.148-4(h)), investors and issuers may integrate certain hedges with qualified debt instruments (Reg. § 1.1275-6), and investors and issuers may integrate a nonfunctional currency debt instrument and one or more qualified hedging transactions (Reg. § 1.988-5(a)).
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 particular, section 1221(a)(7) excludes from tax definition of capital asset “any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe).”

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” contract84) 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 (i.e., marked to market).85

The standards for treating a derivative as a hedge 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 risks related to the hedged item, as demonstrated by prospective and ongoing quantitative analyses,86 while a hedging transaction for tax purposes must merely “manage” risk.87

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 to hedge the interest payments on a floating rate debt instrument held by the taxpayer), 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 to hedge the interest payments on a fixed rate debt instrument held by the taxpayer), 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 hedge 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

85 FASB ASC No. 815-10-10-1(b).
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 the treatment of a transaction.

b. Discussion Draft Proposal

In general, the Discussion Draft deems a tax hedge identification to have been made in situations in which the transaction is properly treated as a hedging transaction in a taxpayer’s audited GAAP financial statements. This provision would apply for hedging transactions entered into after December 31, 2013. As noted in the overview press release that accompanied the Discussion Draft, this proposal (the “Hedging Proposal”) is a “taxpayer-favorable proposal [that] would minimize inadvertent failures to identify a transaction as a hedge for tax purposes” by simplifying the tax hedge identification requirement. Under current rules, an inadvertent failure to identify a tax hedge does not disqualify a transaction from being treated as a tax hedge (and thus gain can be recharacterized as ordinary income).

The Hedging Proposal, however, does not fully adopt a book/tax conformity regime. For example, a U.S. corporation might execute a transaction to manage the foreign currency exchange risk attributable to the net equity of its foreign subsidiary. Under current law, although this transaction may be identified (and treated) as a hedge for GAAP purposes, it is not a hedge for tax purposes. The Hedging Proposal would not change this result.

In addition, even under the Hedging Proposal, not all transactions that qualify for tax hedge treatment would also qualify for hedge treatment for book purposes. An example of this is a transaction that may not be an “effective” hedge for GAAP purposes but that could be viewed as a valid tax hedge. Under the proposal, the absence of a book identification would not preclude the corporation from identifying the transaction as a tax hedge. To be certain to obtain tax hedge treatment in this case, the taxpayer would still need to make a tax-specific identification. Taxpayers may also want to make a specific tax identification to frame the analysis by which a transaction qualifies as a tax hedge.

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88  FASB ASC No. 815-20-25-3.
89  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.
93  For example, a taxpayer may not be able to identify a forward contract in nonfunctional currency as hedging a debt instrument issued by a disregarded entity, on the theory that the debt is non-existent, but may be able to identify the forward contract as hedging an exposure of the disregarded entity.
Thus, while the Hedging Proposal would eliminate the need for many tax-specific identifications, it would not eliminate the need entirely. Indeed, the infrequent need for tax identifications may have the unintended consequence of increasing the frequency of inadvertent failures to make a valid tax identification. However, if such a failure is truly inadvertent, the Service is required to grant tax hedge status to the transaction.94

The Hedging Proposal appears to be mandatory, rather than elective.95 That is, if a taxpayer identifies a derivative transaction as a hedge for financial accounting purposes, and the transaction meets the definition of a hedging transaction, it will be treated as a hedging transaction for tax purposes. Accordingly, all gain or loss with respect to the transaction would be ordinary, and the derivative would be exempt from mark-to-market under the general mark-to-market rule discussed in Part 1.

Under the Discussion Draft, if a transaction is not reported as a hedge for GAAP purposes, and the taxpayer does not identify the transaction as a hedge for tax purposes, the taxpayer would receive mark-to-market/ordinary treatment for the transaction (pursuant to the mark-to-market proposal discussed above) unless it can establish that the failures to identify was due to inadvertent error.96 If the derivative is marked-to-market, the position that it offsets may also be marked-to-market under the mixed straddle proposal.97 Although this may provide a level of symmetry if the hedged item is also a security (e.g., a foreign currency denominated debt instrument), there would still be risk of substantial timing differences under a mark-to-market system if the hedged item is a forecasted exposure (e.g., as in the case of an anticipatory hedge).

c. Committee Comments on Discussion Draft Proposal

We support the inclusion of the Hedging Proposal in the Discussion Draft, which we understand is based on comments submitted on this topic on December 2, 2011, to the Senate Committee on Finance and the House Committee on Ways & Means by the American Bar Association Tax Section (the “2011 Report”).98 The current 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 finance or 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.

94 For a fuller discussion of the Service’s recent approach to the inadvertent error exception, see Shapiro & Mou, Does Section 1256 Incorporate an Inadvertent Error Exception, 128 Tax Notes 1159 (Sept. 13, 2010), 2010 TNT 178-8, Doc. 2010-19516.
95 Prop. I.R.C. § 1221(c).
96 Prop. I.R.C. § 1221(c)(4).
97 Prop. I.R.C. § 485(c).
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, virtually all financial accounting hedges of a risk that is described 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 for tax purposes should also in most instances be treated as tax hedges. Additionally, the financial accounting identification requirements for a 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 the use of hindsight by the taxpayer.

The Discussion Draft’s hedging identification proposal would reduce taxpayers’ need to rely on the inadvertent error exception. As discussed in our prior comments, having separate identification requirements for financial reporting and tax purposes results in situations where a hedge is properly identified for financial accounting purposes but the taxpayer has not made a separate identification for tax purposes. In such a case, a taxpayer must demonstrate that its failure to make a tax identification was due to “inadvertent error” if the derivative is to qualify as a hedge for tax purposes. There is little guidance as to how this inadvertent error standard is to be applied, resulting in uncertainty in cases where the taxpayer fully intended to treat the derivative as a hedge, identified it as such for financial accounting purposes, but failed to make a separate hedging identification for tax purposes. 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. The guiding principle behind the hedge identification requirement is to prevent a taxpayer from using hindsight to determine whether to treat a derivative as a hedging transaction or as a speculative transaction after it is clear whether the derivative has produced a loss or a gain. We believe that a taxpayer’s contemporaneous identification of a derivative as a hedge for financial accounting purposes serves as an adequate check on such use of hindsight.

Adoption of the Discussion Draft proposal on hedging identification will also eliminate an uncertainty that arises under section 1256. 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. Section 1256

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99 We note that this proposal will take on even greater urgency if the Code is amended to provide for mark-to-market treatment for positions in mixed straddles, given that the hedging rules will be the only exception from that regime. It would then be more important than ever for taxpayers to achieve a high level of certainty as to whether a derivative qualifies as a hedge for tax purposes.

100 Reg. § 1.1221-2(g)(1)(ii).
contracts that are properly identified as 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{101} As
originally enacted in 1981, for purposes of section 1256, the definition of a hedging
transaction requires 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.”\textsuperscript{102} The legislative history for this provision indicates 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.\textsuperscript{103}

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, section 1256(e)(2) retains its own same-day identification requirement, without
any provision for an inadvertent error exception.\textsuperscript{104} 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, as discussed in the next paragraph.

The regulations under section 446 (the “hedge timing rule”) govern the timing of
gain or loss resulting from a hedging transaction.\textsuperscript{105} 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.\textsuperscript{106} 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.\textsuperscript{107} Although these hedge timing regulations also contain additional
recordkeeping and identification requirements, compliance with them does not appear to
be a prerequisite for application of the hedge timing rule.\textsuperscript{108} The hedge timing rule
provides that it overrides any inconsistent timing rule in another regulation,\textsuperscript{109} 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. If these
contracts are required to be marked-to-market because the hedge timing rule does not
override the timing rule of section 1256, the timing of recognition of gain and loss on

\textsuperscript{101} I.R.C. § 1256(e).
\textsuperscript{102} I.R.C. § 1256(e)(2).
\textsuperscript{103} Staff of the Joint Committee on Taxation, General Explanation of the Economic Recovery Act of
\textsuperscript{104} Regulation section 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, pursuant to the section 1221 regulations,
a taxpayer shows that it inadvertently identified a transaction as a hedging transaction, then, in accordance
with that position, the transaction will not be treated as 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.
\textsuperscript{105} Reg. § 1.446-4.
\textsuperscript{106} Reg. § 1.446-4(d).
\textsuperscript{108} A willful failure to keep required records may result in penalties under section 7203.
\textsuperscript{109} Reg. § 1.446-4(a).
these contracts will not match the timing of the hedged item, resulting in a distortion of income. It is unclear under current law as to whether the inadvertent error exception is available in situations involving a taxpayer that fails to identify a section 1256 contract as a hedge.\footnote{Of course, the discussion in the text is irrelevant if the mark-to-market proposal in the Discussion Draft is adopted, because part of the proposal would repeal section 1256 in its entirety.}

While the adoption of the Discussion Draft’s Hedging Proposal will reduce the number of instances in which taxpayers must rely on the inadvertent error exception, we recommend that this exception should still be available where the taxpayer makes neither a financial accounting nor a tax hedging identification, if the derivative otherwise qualifies as a tax hedge and the taxpayer can meet the requirements of the inadvertent error exception. Under financial accounting rules, hedge treatment is elective rather than mandatory, and the requirements for making such an election tend to be quite cumbersome. As a result, reporting entities will often not elect financial accounting hedge treatment for derivatives that could qualify, especially when the consequence of not making a hedge identification is less severe for financial accounting purposes than for tax purposes. In such a case, a taxpayer should still be able to rely on the inadvertent error exception with respect to a derivative that otherwise qualifies as a tax hedge if the requirements of the exception are satisfied. We believe that in such cases the inadvertent error exception should be liberally applied based on the principle that the identification requirement is to prevent taxpayers from whipsawing the government through the use of hindsight. In cases where it is demonstrable that such behavior has not occurred, the exception should be available.

We also have two miscellaneous comments on the hedging identification proposal. First, one difference between the financial accounting rules and the tax hedging rules is that a hedge can be “de-designated” for financial accounting purposes. This is sometimes done when an existing hedge ceases to satisfy the hedge effectiveness requirements under the financial accounting rules. We believe that where a taxpayer has relied upon a financial accounting hedge designation as its tax identification, such a “de-designation” for financial accounting purposes should not affect the identification for tax purposes. Second, in situations where a controlled foreign corporation’s (“CFC’s”) parent has audited financial statements, the CFC should be able to rely on the parent’s audited financial statements to avail itself of this “de-designation” rule, even in situations in which the CFC does not itself have separately audited financial statements.

If the mark-to-market and mixed straddle regimes discussed above in Part 1 are included in the ultimate legislation, consideration should be given to making the financial accounting identification rule elective, rather than mandatory. While it likely would not occur frequently, it may be the case that a taxpayer does not wish to mark to market a derivative for financial accounting purposes, and thus designates the derivative as a hedge for financial accounting purposes, but is willing to mark the derivative to market for tax purposes under the mark-to-market and mixed straddle regimes. From a policy perspective, there is no reason to prevent a taxpayer who for tax purposes is willing to mark to market both a derivative and the asset it hedges from doing so. However, if a
derivative is identified as a hedge for financial accounting purposes (and thus is not marked for such purposes), and the derivative is eligible for tax hedging treatment (and thus need not be marked to market under the Discussion Draft), most taxpayers will not wish to mark to market that derivative. Thus, the default rule should be that a taxpayer who identifies a derivative as a hedging transaction for financial accounting purposes should be deemed to intend to treat such derivative as a hedge for tax purposes as well, but a taxpayer should be permitted to affirmatively elect out of this default rule by placing a statement to that effect in its tax books and records.

3. Modification to Treatment of Debt Instruments

The Discussion Draft includes four provisions relating specifically to the taxation of debt instruments. Two are relatively minor provisions in the nature of technical corrections. The other two provisions are designed to address problems under current law with the tax treatment of so-called distressed debt. Both of these provisions are drawn from the 2011 Report. In general, our Committee supports the debt-related provisions of the Discussion Draft. We have a number of suggestions, however, for improving these proposed statutory provisions. Furthermore, we believe the Discussion Draft is significantly deficient in its failure to include one of the important legislative options set forth in the 2011 Report, and we urge you to include this provision in any tax reform legislation that moves through Congress.

a. Issue Price of New Debt Following a Modification

Under present law, if the terms of a debt instrument are modified, the modification will be treated as a deemed exchange for U.S. federal income tax purposes 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. In the context of a debt restructuring or workout, the modifications necessary to enable the issuer to service the debt, such as changes in the yield or timing of payments, almost invariably will be economically significant. In that case, the existing debt will be treated as satisfied for an amount of money equal to the issue price of the modified debt. To the extent that the issue price of the modified debt is less than the adjusted issue price of the existing debt, the issuer will recognize income from cancellation of debt (“COD income”) under section 108(e)(10) of the Code, even if the principal amount of the debt is not reduced. Under present law, the issue price of a debt instrument that is publicly traded (defined broadly to include most debt for which pricing information is generally available) is its fair market value. Because the fair market value of debt that is being restructured typically will have declined since its issue date, an issuer of publicly traded debt is likely under present law to recognize COD income as a result of the workout.

Under proposed section 1274B of the Code (section 411 of the Discussion Draft), in the case of any “specified debt modification,” the issue price of the modified debt

111 I.R.C. § 108(e)(10) applies to the issuer of debt even if the transaction qualifies as a tax-free recapitalization for the holders of the debt.
instrument would be the lesser of (1) the adjusted issue price of the existing debt instrument, or (2) the issue price of the modified debt instrument as would be determined under section 1274 if that section applied to the debt instrument.\textsuperscript{112} Regarding the second prong, the issue price of a debt instrument determined under section 1274 is its stated redemption price at maturity if it bears adequate stated interest, based on the applicable federal rate ("AFR"),\textsuperscript{113} or its imputed principal amount, using the AFR as the discount rate, if it does not bear adequate stated interest.\textsuperscript{114} Thus, under proposed section 1274B, assuming the modified debt bears adequate stated interest and the principal amount is not reduced, its issue price would be the same as the adjusted issue price of the existing debt (which is its face amount if the existing debt was issued without OID). As a result, the proposed rule is effectively a nonrecognition rule for debt issuers; the issuer generally will not recognize COD income under section 108(e)(10) under proposed section 1274B unless the principal amount of the debt is reduced or the modified debt does not bear adequate stated interest.\textsuperscript{115} We think this is an entirely appropriate result, and accordingly we support enactment of proposed section 1274B.

We do wish to raise one technical issue. A "specified debt modification" is an exchange by an issuer of a new debt instrument for an existing debt instrument issued by such issuer, or the significant modification of an existing debt instrument, including one that the issuer and holder accomplish indirectly through one or more transactions with unrelated parties. We note that because the definition of "specified debt modification" under proposed section 1274B addresses exchanges and significant modifications separately, there is a possible implication that if there is an actual exchange of debt by the issuer, the issue price of the modified debt would be determined under section 1274B even if there is no significant modification of the debt that is treated as an exchange for U.S. federal income tax purposes.\textsuperscript{116}

\textsuperscript{112} The second prong prevents the issuer from taking the position, as may have been possible under section 1275(a)(4) prior to its repeal in 1990, that even if the principal amount were reduced, the issue price of the modified debt could not be less than the adjusted issue price of the existing debt, resulting in bond premium on the modified debt instead of COD income. As noted in the technical explanation accompanying the Discussion Draft, it also prevents the avoidance of COD income by forgiving interest rather than principal.
\textsuperscript{113} I.R.C. §§ 1273(b)(4), 1274(a)(1); Reg. §§ 1.1273-2(d)(1), 1.1274-2(b)(1).
\textsuperscript{114} I.R.C. § 1274(a)(2); Reg. §§ 1.1273-2(d)(1), 1.1274-2(b)(2). In determining the adequacy of the stated interest on the modified debt, it is not entirely clear whether the AFR in effect at the time of the original issuance or the modification should be applied. The view of our Committee is that the AFR from the earlier time is more sensible, since the objective of the second prong is to prevent avoidance of COD income, including by forgiving interest. A secondary question is whether the appropriate AFR (short-term, mid-term or long-term rate) should be based on the term of the original debt, the term of the modified debt (if it is extended), or the remaining term to maturity of the modified debt. In the interest of simplicity, we would recommend that the original term of the debt be used, so that there can never be COD income if neither the principal amount nor the interest rate is reduced.
\textsuperscript{115} The holder's amount realized would be the issue price of the new debt instrument, and the recapitalization rules would continue to apply to the holder to the extent they would apply under current law.
\textsuperscript{116} Regulation section 1.1001-3 applies to any modification of a debt instrument, regardless of whether the modification occurs by exchange or amendment or indirectly through one or more transactions with third parties, but does not apply to exchanges between holders.
The technical explanation accompanying the Discussion Draft indicates, however, that proposed section 1274B is not intended to change the definition in the regulations of when a significant modification constitutes an exchange, so presumably this technical issue will be clarified in the legislation as enacted. We think it is important that either the statute be clarified or at least that this explanation be retained as part of the legislative history of this new rule as it moves through Congress. Consistent with this point, for the balance of this report, all references to significant debt modifications include debt-for-debt exchanges, but only those that would be treated as significant modifications if undertaken in that form.

b. Debt modifications should also be nontaxable exchanges for debt holders, with carryover basis.

The 2011 Report contained a legislative option relating to the tax treatment of holders of debt when the debt is significantly modified or exchanged for another debt of the same issuer with materially different terms but the same principal amount. Under this option, the transaction would be treated as a nontaxable exchange in which the holder would generally not recognize gain or loss, and the basis in the existing debt would carry over to the modified debt. The Committee continues to believe that this proposal has merit and, with one refinement discussed below, should be included as a companion rule to proposed section 1274B. Our reasons for supporting such a legislative change are set forth in the 2011 Report and are summarized (and to some extent clarified) below.

First, our Committee believes that the substitution of one debt obligation for another obligation of the same issuer with the same principal amount but modified terms (including interest not less than the AFR) simply is not an appropriate time to require income or gain to be recognized, by either the issuer or the holder. Although certain terms of the debt may have changed, the issuer continues to be liable for the same amount, and on the other side of the transaction, the holder has an asset representing a continuing investment in the issuer of the same amount, usually including the same creditor’s rights in bankruptcy.\footnote{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).} In this respect, an exchange of debt instruments or deemed exchange resulting from a debt modification differs fundamentally from an exchange of debt for cash or other property in which the debt is extinguished. In a debt modification in which the principal amount does not change and the interest rate does not drop below the AFR, the most important features of the holder’s asset and the issuer’s liability remain the same, and neither the issuer nor the holder experiences an accession to wealth solely as a result of the modification. Importantly, the fisc retains the same opportunity to impose tax on the issuer and the holder with respect to the debt instrument. These facts underpin the nonrecognition treatment of the issuer under proposed section 1274B, and they similarly support nonrecognition treatment for the holder.

The reason a separate nonrecognition rule is necessary for debt holders is that holders of debt include not only original lenders but also secondary market purchasers of
debt. There is no corresponding phenomenon on the borrower side.\textsuperscript{118} For original lenders, proposed section 1274B would achieve a sensible result that generally parallels the borrower’s treatment: because the original lender’s basis in the debt generally equals the adjusted issue price of the debt, which is also the amount realized on the deemed exchange, no gain or loss is recognized except to the extent the principal amount of the debt is reduced in the modification or exchange. For secondary market purchasers who have acquired the debt at a significant discount, however, there can be a tax gain without any corresponding actual economic gain. For this reason, the gain may be thought of as “phantom gain.”

This phantom gain results from the fact that, under current law for debt that is not publicly traded,\textsuperscript{119} and under proposed section 1274B for all debt instruments, the issue price of modified debt generally will be equal to its stated principal amount,\textsuperscript{120} which almost inevitably will exceed the debt’s fair market value.\textsuperscript{121} Therefore, unless the exchange qualifies as a corporate recapitalization (discussed below), a secondary market holder that acquired the debt at a discount will recognize gain based on the difference between the holder’s low basis in the existing debt and the high issue price of the modified debt.\textsuperscript{122} We believe that recognition of gain or loss on a modification of a debt instrument is generally inappropriate\textsuperscript{123} and that the recognition of phantom gain is particularly inappropriate.\textsuperscript{124}

Notably, the Code already contains a rule mandating nonrecognition treatment for the holder in certain cases. Currently, if a debt modification qualifies as a recapitalization under section 368(a)(1)(E), gain or loss is not required (or permitted) to be recognized by the holder. In order for a debt modification to qualify as a recapitalization within the meaning of section 368(a), the issuer of the debt must be a corporation, and both the

\begin{itemize}
  \item A change in obligor generally results in a new debt being issued for tax purposes except in cases in which the new obligor effectively steps into the shoes of the old obligor. Reg. § 1.1001-3(e)(4). Hence, the obligor is either the original borrower or has the same tax position as the original obligor.
  \item Under current law, the issue price of the debt that is not publicly traded is determined under section 1274, rather than based on fair market value. This generally results in an issue price equal to the face amount of the debt. Revisions to the Treasury regulations governing the definition of publicly traded, effective in November 2011, significantly expanded the class of debt instruments treated as publicly traded.
  \item In general, a lender will not want to reduce the principal amount of a debt instrument to the debt’s fair market value because it will reduce its rights in a foreclosure or bankruptcy.
  \item The gain generally can be reported under the installment method, but may be subject to a deferred interest charge under section 453A.
  \item The suggested nonrecognition rule would not constitute a legislative reversal of Cottage Savings v. Comm’r, 499 U.S. 554 (1991). Cottage Savings involved exchanges of pools of mortgage loans with different mortgagors and different underlying properties. The recommended statutory change would affect only debt exchanges and modifications in which the issuer of the debt does not change. However, the suggested change would largely render nugatory the regulations in Regulation section 1.1001-3 from the holder’s perspective.
  \item If only the holder’s treatment were at stake, the phantom gain problem could be cured by making the holder’s amount realized on the exchange equal to the fair market value of the debt rather than its issue price. But this would be inconsistent with proposed section 1274B and with the general principle that led Congress to enact section 1274 – it is difficult to determine the fair market value of a debt instrument reliably unless it is publicly traded.
\end{itemize}
existing and modified debt must constitute “securities” for purposes of the corporate reorganization rules. If these requirements are met so that the exchange or modification constitutes a recapitalization, then regardless of the tax consequences of the transaction to the issuer, the holder does not recognize gain or loss and takes a carryover basis in the modified debt. We believe that limiting nonrecognition treatment to recapitalizations is irrational and that nonrecognition treatment for holders should be extended to debt exchanges generally.

The recapitalization requirements create an arbitrary distinction between economically similar transactions. There is no clear policy basis for limiting nonrecognition treatment to holders of debt issued by corporations, since many business enterprises comparable to corporations in terms of size, complexity and creditworthiness are organized in non-corporate form. Further, the requirement that the existing and modified debt instruments qualify as securities under section 354, which depends primarily on the original term of the debt being modified, does not apply sensibly in the debt-workout context. We can see no policy reason why a holder of long-term debt that is significantly modified should receive tax-free treatment while a holder of modified short-term debt should have a taxable exchange.

In addition to avoiding phantom gain recognition by holders and the arbitrary nature of the recapitalization rules, a rule mandating nonrecognition treatment for holders in debt modifications will tend toward symmetry between the issuers and holders, since (unless the modified debt does not bear adequate stated interest or the principal amount is changed) neither will recognize gain or loss. Symmetry does not always make sense in the debt context, such as triggering issuer income or loss based on secondary market trading between holders, but where the issuer and holders are counterparties to the same transaction, matching is generally desirable. In that connection, eliminating situations in which holders face the prospect of recognizing phantom gain will align the interests of the issuer and holders and make appropriate debt restructurings more likely to occur.

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125 I.R.C. § 354(a).
126 The meaning of the term “security” in section 354 has not been clearly defined by case law, the Code or Treasury regulations, but in general, whether a debt instrument is a “security” for these purposes turns on whether it constitutes a continuing investment in the issuer. This determination is based on all the facts and circumstances, one of the most important of which tends to be the original term of the instrument, particularly a term exceeding five years. In the context of a debt modification, however, the original term of the existing debt arguably is not as relevant as the remaining term of the existing debt and the term of the modified debt, particularly where the holder may have acquired the debt in the secondary market only a short time before the deemed exchange.
127 The reorganization rules developed in the two-party acquisition context, where the inquiry revolves around whether the consideration received by the target stakeholders from the acquirer represents a continuing interest in the target. Where neither the issuer nor the principal amount changes, the most salient aspects of the investment holder’s investment in the issuer’s debt remain constant, so that the modified debt in the holder’s hands represents just as much of a continuing interest in the issuer as the existing debt, regardless of whether the debt is short-term or long-term.
130 An exception might be provided for a case in which the holder can demonstrate that the issuer remains in financial distress.
130 An exception might be provided for a case in which the holder can demonstrate that the issuer remains in financial distress.
Note that a holder nonrecognition rule encompasses both gains and losses, so that the holder would not be permitted to recognize a loss if its basis exceeded the issue price of the modified debt, even in cases where the principal amount of the debt was reduced. It is appropriate in that case to require the issuer to recognize COD income, since its legal obligation to repay the principal has been reduced. The holder, in contrast, may or may not have realized a loss from the reduced principal amount, depending on factors such as the holder’s basis in the debt and the value of the debt at the time of the reduction, which generally will vary significantly between initial and secondary market purchasers (and may not be directly related to the issue price of the debt under proposed section 1274B). Instead, the holder would simply have carryover basis in the modified debt, with all of the consequences that would flow from any difference between that basis and issue price of the debt under the bond premium and market discount rules.

Further, the holder nonrecognition rule similarly should extend to the relatively rare circumstance where, in a debt-for-debt exchange or modification, the principal amount of the debt is increased. Under proposed section 1274B, in such cases, the new or modified debt generally will be treated as issued with OID, because its issue price will tend to be the (lower) adjusted issue price of the existing debt. Rather than requiring the holder to recognize gain currently based on the increased principal amount, the holder would recognize additional ordinary income over the term of the debt under the OID accrual rules.

Our Committee recognizes that an unlimited nonrecognition rule for holders of debt may result in inappropriate deferrals of gain recognition in the case of extensions of the maturity date of debt purchased at a discount. This might occur if the borrower has resolved its financial distress and the debt holder and borrower wish to roll over the maturing debt into a new loan. Therefore, in a refinement to the option presented in the 2011 Report, we propose that the holder nonrecognition rule apply only to modifications of debt instruments in which the maturity of the debt remains within the safe-harbor period of Regulations section 1.1001-3(e)(3)(ii), meaning the lesser of five years or 50% of the original term. Holders to which the nonrecognition rule does not apply (because the term is extended beyond the safe harbor period) would be required to recognize gain based on the issue price of the debt under proposed section 1274B.

c. Amortizable Bond Premium

i. Above-the-line deduction for amortizable bond premium

The Discussion Draft would amend section 171 to provide that a deduction for amortizable bond premium under section 171(a) is treated as an above-the-line deduction. While our Committee thinks that the goal of this proposal is laudable, we think it is unnecessary in view of the fact that section 171(a) is almost entirely superseded by section 171(e). The latter subsection makes amortizable bond premium an offset to interest income rather than a

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130 An exception might be provided for a case in which the holder can demonstrate that the issuer remains in financial distress.
separate deduction item. As a result, any limitation imposed on deductions of individual taxpayers is inapplicable to amortizable bond premium.

ii. Amortizable bond premium should be amortized using economic principles

We believe that if any change is to be made to the rules governing amortizable bond premium, it should be to replace section 171(b)(1)(B)(ii) with a provision having the opposite effect. That Code section provides that, in the case of a taxable bond that is callable prior to maturity, the issuer will be presumed to exercise or not exercise that call right in the manner that results in the slowest amortization of premium. This rule is contrary to both economic reality and how the OID rules operate with respect to issuer call rights. The exact opposite rule should prevail – premium should be amortized to the call date and call price or to the maturity date and redemption price, whichever results in the faster amortization of premium.

The current rule is equivalent to a presumption that the issuer of a callable taxable bond will choose to exercise or not exercise a call right based on the choice that results in the highest yield to maturity. This obviously does not correspond to economic reality – issuers of debt will act to minimize their yield (a measure of their borrowing cost), not to maximize it. As noted above, this presumption applies for purposes of determining the accrual of OID, and there is no reason it should not apply for purposes of determining the amortization of premium.

Were it not for the regulations under section 171, this arguably could be accomplished by simply repealing section 171(b)(1)(B)(ii). However, since Regulation section 1.171-3(c)(4) embodies the current statutory rule (and expands it to cover multiple options), the better approach would be to amend section 171(b)(1)(B)(ii) to replace the word “smaller” with “larger” for bonds acquired after the effective date of the change.

   d. Market Discount Rules

   i. Summary of the Discussion Draft

   113 Reg. § 1.1272-1(c)(5).
   114 Congress’s reason for enacting section 171(b)(1)(B)(ii) appears to have been to prevent a perceived abuse based on a bond issued at a premium with an issuer call right that was exercisable shortly after the bond was issued but was not expected to be exercised and was included only to allow holders to amortize the premium to the call date. It is questionable whether such an abuse could actually exist, for the holders of the bond would be taking the risk of having the bond actually paid off early, thereby losing the benefit of the premium paid, so would be unlikely to pay a premium premised on the bond staying outstanding for its entire term. In any event, the statute goes well beyond what is necessary to prevent abuses, and the anti-abuse rule in Regulation section 1.1275-2(g) would seem adequate to deal with any abuses that might actually arise.
For debt instruments acquired after 2013, the Discussion Draft would change the treatment of market discount in a number of important respects. First, market discount would have to accrue on a yield-to-maturity basis. Second, market discount would accrue at a maximum rate equal to the greater of (1) the AFR at the time of purchase plus 10 percent or (2) the original yield to maturity of the debt instrument plus 5 percent. Third, taxpayers would have to include market discount in income as it accrues.

ii. Mandatory Use of Yield to Maturity for Market Discount Accruals

The Committee supports the proposed requirement that market discount be included in income on a yield-to-maturity basis. In 1984, when the market discount rules were enacted, yield to maturity concepts were relatively unfamiliar and computing software to compute yield-based accruals was not widely available. Today, yield concepts are more widely understood and, more importantly, programs to compute yield-based accruals are widely available. Furthermore, with the expansion of broker reporting, most individual taxpayers can receive reports of market discount accruals from their brokers.\textsuperscript{133}

iii. Limitation on Yield to Maturity for Purposes of Determining Market Discount Accruals

The Committee fully supports the establishment of a maximum rate at which market discount accrues. As explained in the 2011 Report, this change will greatly reduce the distortion in the measurement of taxable income when a debt instrument is acquired at a deep discount due to the borrower’s financial distress (or, in the case of asset-backed securities, anticipated defaults on underlying loans). The yield cap is taken directly from the 2011 Report and the Committee continues to believe that this is a reasonable cap on market discount accruals.

Nevertheless, the Committee thinks that the determination of the yield cap can be improved in several respects. First, we believe that Congress should grant regulatory authority to the Secretary to alter the yield cap as necessary to reflect changes in market conditions. For example, the first component of the cap (AFR + 10 percent) is premised on the notion that newly issued debt of the least creditworthy borrowers does not have a yield more than 10 percent above the yield on Treasury obligations of a comparable maturity. If market conditions change markedly, so that this spread significantly widens or narrows, we believe it would be appropriate for Treasury and the Service to alter the maximum rate of accrual of market discount by regulations or other appropriate guidance.

Second, we think that the second component of the cap formula might be refined to better accomplish its intended purpose, which is to subject a debt instrument to the yield cap if, but only if, the issuer’s creditworthiness has declined significantly from the

\textsuperscript{133} If proposed section 1278 is enacted, it is assumed that conforming amendments will be made to the regulations under section 6049, requiring brokers to compute and report the accrual of market discount on Form 1099.
time the debt was issued. A test based on the debt’s change in yield from the time of issue, however, is both underinclusive and overinclusive, because it incorporates both changes in generally prevailing interest rates and changes in the creditworthiness of the borrower. For example, if the issuer’s creditworthiness declines significantly but generally prevailing interest rates fall from the time a debt instrument is issued, the two changes could offset sufficiently so that the overall change in the yield on the debt instrument might not exceed the 5-percent threshold required by the test in the Discussion Draft to trigger the yield cap. Conversely, if generally prevailing interest rates increase from the time a debt instrument is issued, the yield cap could be triggered even if the issuer’s creditworthiness remained constant or improved.

A better but admittedly somewhat more complex approach to the second prong would be to measure the spread of the debt’s original yield over the AFR at the time the debt was issued, and to base the second component of the cap on an increase in that spread over the AFR at the time of purchase of at least 2 percent. For example, if a debt instrument were issued at a 12% yield when the AFR was 3%, the spread of the debt’s yield over the AFR at the time of issue would be 9%, so the yield cap under the second prong would be 11% above the AFR at the time of purchase. Consequently, if a secondary market purchaser acquired the debt instrument when the AFR was 5%, the yield cap under the second prong would be 16%. Thus, under this formulation, the second prong of the test would be controlling only in cases in which the debt’s yield at the time of issue was within 2 percent of the yield cap at the time of issue.

While this increase in spread does not guarantee that the issuer’s creditworthiness has declined (because changing market conditions can cause a widening or narrowing of spreads generally), this test is an improvement over the test in the Discussion Draft, is relatively easily to apply, and is likely as good at accomplishing the intended purpose of the test as possible given the need for an objective and administrable rule. With this refinement, the Committee believes that 2 percent is a sufficiently large increase in yield to accomplish the intended purpose of this rule.

Thus, with the proposed change, the maximum rate of accrual for market discount would be the AFR at the time of purchase plus a spread equal to the greater of (1) 10 percent, or (2) 2 percent plus the excess of the yield at the time of issue over the AFR at the time of issue.

Next, the Discussion Draft provides that, if the yield cap applies, the base upon which the investor’s maximum yield accrues is initially equal to the present value of the remaining payments on the debt instrument, discounting at the maximum yield. This is an approach that should be changed. As discussed above, the rationale behind the proposal in the Discussion Draft is that an investor should not be required to accrue interest at a rate that exceeds the yields on the riskiest of newly issued debt instruments. But an investor’s accrual should be based on its amount invested, not on a hypothetical amount that the investor would have invested had there been less risk in the investment. Accordingly, the base to which the maximum yield applies should equal the investor’s actual purchase price. Without this change, the proposed legislation will not accomplish
its intended purpose and indeed in some situations will produce a result that is harsher than current law.

An example will show how the Discussion Draft operates and how it needs to be revised. Suppose that a bond has 7 years remaining to maturity and calls for semiannual interest at a rate of 6 percent. The issuer is in severe financial distress, so Taxpayer T buys a $1 million bond from this issue for 20 percent of its face amount, i.e., $200,000. T’s yield to maturity is 42.35 percent, compounded semiannually. Assume that the yield cap under the Discussion Draft is 13 percent.

Under the current version of the Discussion Draft, the base to which the yield cap applies is the present value of the remaining payments on the bond discounted at a rate of 13 percent, which is $684,516 and is more than three times greater than the amount T actually invested in the bond. The accrual in the first semiannual period would be $684,516 × 13%/2 = $44,494. Without the yield cap, the accrual in the first period based on T’s purchase price would be $200,000 × 42.35%/2 = $42,350, which is less than the accrual under the statutory language of the Discussion Draft. The appropriate answer, if the Discussion Draft is to accomplish its intended purpose, is that the accrual in the first period should be $200,000 × 13%/2 = $13,000.

The Discussion Draft provides that, subject to the yield cap, market discount must be included in taxable income as it accrues for all market discount bonds acquired after 2013. The Committee generally supports this provision, which was one of the options in the 2011 Report. If and when interest rates rise again, and debt begins trading at a discount because of higher interest rates, a tax system that taxes market discount on a cash basis, while taxing OID and stated interest on an accrual basis, would create a tax incentive for taxpayers to invest in market discount bonds rather than newly issued bonds with higher stated rates, and hence would create distortions in the capital markets.134

It is important to note, however, that even with a yield cap in place, market discount is not fully equivalent to stated interest and OID. Part of the rationale for requiring even cash-method taxpayers to include OID in income as it accrues is that issuers of debt are usually accrual-method taxpayers, and allowing OID to be included on the cash method would create a mismatch between borrower deductions and investor inclusions. This is not true of market discount, because the borrower has no deduction corresponding to the investor’s market discount income. Further, for an investor in deeply distressed debt, it is not clear that any portion of the market discount is equivalent to interest, with or without a yield cap. For example, if a borrower is on the verge of failure, its debt will trade at a price largely determined by what an investor could expect to collect in a bankruptcy proceeding. That amount does not grow over time based on an interest-like accrual; it is determined entirely by the value of the borrower’s assets and the debt’s priority relative to other creditors.

134 The same considerations do not apply to tax-exempt bonds. Unless Congress extends tax-exempt treatment to market discount, which seems highly unlikely, there will necessarily remain a tax distinction between market discount and stated interest on tax-exempt bonds.
e. Possible extension of maximum yield to all accruals on debt, whether stated interest, OID or market discount

The Committee believes that Congress should consider a more far-reaching reform to the taxation of debt instruments that places a maximum rate at which interest accrues for tax purposes, whether in the form of stated interest, OID or market discount. Such a limitation would address a number of tax problems not covered by a yield cap that applies only to market discount. We believe that it would be appropriate to apply this limit to both issuers and holders of debt.

First, a limit on the total accrual would more effectively address the distressed-debt situation. In many cases of investment in deeply distressed debt, the stated interest alone exceeds any reasonably expected return on the investment. Although stated interest may accrue at a modest rate, it must be borne in mind that the stated interest rate applies to the full principal amount of the debt, not the investor’s purchase price. As a result, the stated interest can be a huge percentage of the amount of the investment in distressed debt.

Reconsider the example above. The stated interest in each semiannual period is 3 percent of the debt’s principal amount, or $30,000 for a bond with a face amount of $1 million. For the investor who purchases the bond for $200,000 and is subject to a yield cap of 13 percent, the accrual during the first semiannual period is only $13,000 under the recommendation in these comments – far less than the stated interest of $30,000. Thus, a statutory rule that applies only to the accrual of market discount does not materially reduce this investor’s income accrual unless the rule is interpreted to allow the $17,000 excess of the stated interest over the total accrual at the capped yield as a current period deduction. While the rule protects the investor from having to accrue a portion of the market discount, it falls far short of limiting the investor’s accrual to a 13 percent rate of return on the $200,000 investment. In effect, if the investor is required to include the stated interest in income as it accrues, it will be including income at a rate of 30 percent on the investment (6 percent stated rate divided by a purchase price equal to 20 percent of face) with respect to stated interest alone.

Second, a cap on total yield accrual will lessen inappropriate accruals of discount on certain mortgage-backed securities. Mortgage-backed securities are most often issued in the form of REMIC regular interests, which are deemed to be debt instruments for tax purposes, no matter how likely they are to suffer losses of principal from defaults on the underlying mortgage loans. Further, the accrual of interest and OID must be computed without regard to the possibility, indeed the likelihood, of losses from defaults. As a result, the nominal yield on certain mortgage-backed securities (i.e., the yield computed on the assumption of no losses from defaults) can be well in excess of a realistic market rate of interest. Extending the yield cap to these types of securities could greatly reduce or even eliminate the distortion that arises from the assumption that future losses from defaults will be zero.
Third, in today’s complex marketplace, it is often difficult to distinguish between debt and equity, especially with regard to loans to newly created businesses. Loans to such entities often have yields of 20 percent or more and yet are treated as debt by both the investor and the borrower. Some of these arrangements might be challenged by the Service on the ground that the lender is taking risks more consistent with being an equity investor, as evidenced by the high stated rate of return. A yield cap, applicable to both the borrower\textsuperscript{135} and the investor, might be a good way to lessen this tension and hence remove disputes from the tax system.

If the yield cap were extended to interest and OID, the second part of the yield cap would seem unnecessary and inappropriate (because a cap based on an increase from the initial yield cannot apply to the initial yield). Hence, the Committee would recommend a simpler yield cap equal to the AFR at the time of issue or purchase, as appropriate, plus a spread of 10 percent (again with authority given to the Treasury to adjust the spread as appropriate to reflect market conditions).

f. Character of loan losses

When an investor holds a debt instrument as a capital asset, any loss on the debt is generally a capital loss. This rule seems natural and appropriate to the extent loss relates to the taxpayer’s original investment, but if a taxpayer has included accrued interest, market discount or OID on the debt in income and then incurs a loss due to the failure of the taxpayer to collect the full amount owed on the debt, fairness requires that the loss be ordinary to the extent of the ordinary income taken into account with respect to the debt investment, even if the taxpayer has received amounts corresponding to such accrued interest, market discount, or OID. While the yield cap in the Discussion Draft will lessen the incidence of the accrual of interest or discount that is not actually collected, it certainly will not eliminate such situations. Accordingly, the Committee suggests that Congress enact a new statutory rule providing that a taxpayer’s loss on the sale or exchange of a debt instrument (including a deemed exchange upon retirement) be treated as an ordinary expense to the extent of the amount of accrued interest, OID and market discount the taxpayer has included in income.

g. Codification of the doubtful collectability exception (DCE) and its application to OID, market discount and issuers of debt

Beginning with the 1930 decision of the Second Circuit in\textit{Corn Exchange Bank v. United States},\textsuperscript{136} tax common law has reflected the principle that a taxpayer using the accrual method of accounting need not include an accrued amount in taxable income if at the time of the accrual there is no reasonable expectation that the accrued amount will be collected. While this common law rule has operated reasonably well, the Committee believes it would be desirable for Congress to codify the common law rule and clarify its

\textsuperscript{135} The yield cap applicable to the borrower should be based on the original yield and issue price of the debt instrument and should not change based on the price at which the debt changes hands in the secondary market.

\textsuperscript{136} \textit{Corn Exchange Bank v. United States}, 37 F.2d 34 (2d Cir. 1930).
application in several respects. First, the statutory version of this rule should apply to interest, OID and market discount, not simply stated interest. 137 Second, it should be made clear that the test is applied at the close of the taxable year in which the accrual occurs. Third, the statutory rule should set forth the standard that accrual should cease at the point at which there is no reasonable possibility that the taxpayer will receive an amount on the debt instrument that exceeds the taxpayer’s basis in the debt instrument. 138 Again, although the yield cap in the Discussion Draft will reduce the extent of the accrual of interest or discount as to which there is no reasonable expectation of collection, it certainly will not eliminate such situations. Finally, the rule should be extended to issuers of debt, so that interest deductions cease at the point at which there is no longer any reasonable possibility that the issuer will be able to pay more than the adjusted issue price of the debt.

h. Exclusivity

If Congress were to adopt all of the Committee’s suggestions in this part of our report, this might well be characterized as a comprehensive system for dealing with tax issues arising from distressed debt. However, given the far-reaching nature of at least some of the Committee’s proposals, such comprehensive change seems unlikely. Accordingly, if Congress does not enact all of these provisions, it is important that Congress not imply that the provisions that are enacted supersede common law rules with respect to distressed debt. The Committee requests that this be stated explicitly in the legislative history to the provisions that are enacted.

i. Extension of Market Discount Rules to Certain Bonds Held by Partnerships

Proposed section 1279(a)(6) would require partnerships to determine if a debt instrument has market discount not only when the partnership acquires the debt instrument (as is the case under current law) but also any time a partner transfers its partnership interest in a transaction to which section 743 applies. 139 Essentially, the proposed statute would apply an aggregate approach to the partnership for purposes of applying the market discount rules. As a result, a debt instrument that a partnership acquired without market discount could be treated as a market discount bond with respect to a transferee partner if a section 743 adjustment reduced the transferee partner’s inside basis in its share of the debt instrument below the stated redemption price at maturity of that share of the debt instrument (or the adjusted issue price in the case of a debt

137 This would reverse the position that the Internal Revenue Service took in Technical Advice Memorandum 9538007 (Sept. 22, 1995).
138 For example, if the taxpayer’s basis in a debt instrument at the beginning of a taxable year is 60, interest of 3 accrues during the year, and at the close of the year the taxpayer has no reasonable expectation of collecting more than 61, the taxpayer would include only 1 in income, thereby increasing basis to 61.
139 Very generally, section 743 prevents a transferee partner from inheriting built-in gain or loss in its ratable share of the partnership’s assets by stepping up or stepping down the transferee partner’s inside basis in its ratable share of those assets to fair market value. This section 743 adjustment does not affect the inside (or outside) basis of the other partners. As a general rule, a partnership must make an election under section 754 for section 743 to apply. A partnership must make a section 743 adjustment, however, even if it has not made a section 754 election if has a substantial built-in loss in its assets. See I.R.C. § 743(d).
instrument with OID). The other partners, however, would continue to treat the debt instrument as not having market discount.\(^{140}\)

As a general matter, most members of our Committee support this proposed rule, as the aggregate approach to applying the market discount rules seems consistent with basis adjustments for individual partners in section 743. We do, however, have some concerns.

First, the proposed rule will impose significant additional administrative burdens, particularly on large partnerships. If a partnership has frequent transfers to which section 743 applies, it must not only keep track of each partner’s basis in each bond that it holds but also compute the accrued market discount for each partner whose share of a bond is treated as having market discount (or give the partner the information to allow the computation to be made). In addition, the partnership would have to make current 704(c)-like allocations to transferee partners in respect of market discount that arises from a section 743 adjustment, a concept that appears to be unique. Additional complexity will arise if a partnership making these allocations has adopted an aggregate allocation method under Regulation section 1.704-3(e)(3).

Second, the proposed rule’s application of the aggregate approach is not applied consistently. With regard to the Code’s time-value-of-money rules, if a section 743 adjustment is to be treated as a deemed purchase by a transferee partner for market discount purposes, it would seem that it should also be so treated for purposes of the bond premium and acquisition premium\(^ {141}\) rules. More generally, consistency would seem to require that a section 743 adjustment be treated as a deemed purchase for a variety of other purposes, including determining the transferee partner’s holding period in its ratable share of the partnership’s assets. Such adjustments would exacerbate the administrative issues described previously. For example, a partnership would have to track multiple acquisition dates for a single asset for purposes of applying the wash sale rules in section 1091.

Moreover, there are various other problems involving the interaction between the partnership rules and the market discount rules that would seem equally deserving of resolution by statute. For example, if a partnership holds a bond that is not a market discount bond in the hands of a partnership and distributes the bond to a partner in a transaction in which the partner takes a low basis in the bond for reasons unrelated to the fair market value of the bond, the bond should not be treated as a market discount bond in the hands of the distributee partner. Another issue arises when a partner contributes a debt instrument to a partnership whose value differs from its basis, thereby causing a book/tax disparity.\(^ {142}\) The Committee believes that if Congress is to reform the

\(^{140}\) Conversely, a debt instrument that a partnership acquired with market discount could be treated as not having market discount with respect to the transferee partner if a section 743 adjustment increased a partner’s basis in its ratable share of the debt instrument.

\(^{141}\) See I.R.C. § 1272(a)(7) and Reg. § 1.1272-2(b)(3).

\(^{142}\) See Garlock, Federal Income Taxation of Debt Instruments, 6th Ed., ¶1308.01[A].
interaction between the Code’s debt and partnership rules, this should be done in a comprehensive, rather than piecemeal, fashion.

j. Rules Governing Certain Government Debt

The Discussion Draft would repeal section 454 and would take the one aspect of section 454 that remains relevant under current law and move it to a new section 1272A, effectively limiting its application to United States savings bonds. Section 454(a) provides that if a taxpayer owns a zero-coupon bond and does not otherwise include the accretion in value of the bond in income, it can elect to do so. Since the OID rules generally require taxpayers to include discount on such bonds in income as it accrues, this rule is relevant only for bonds exempt from the OID rules. The only significant exemptions from the OID rules are for tax-exempt bonds, United States savings bonds, and short-term obligations. Section 454(b) provides that discount on a short-term obligation does not accrue until the maturity date of the bond. This subsection has completely been superseded by sections 1271(a)(3) and (4) and sections 1281-83 (and is generally inconsistent with these provisions except for certain cash-method taxpayers).

Our Committee supports the repeal of section 454. As for proposed section 1272A, we have no strong objection to the proposed statute, but we doubt many purchasers of United States savings bonds will want to elect current taxation of the accretion in value of those bonds. Perhaps the Service could provide statistics or at least anecdotal evidence of whether taxpayers have made current inclusion elections under section 454(a). Unless such evidence shows that the election has been made by a significant number of taxpayers, it would appear that the Code could be simpler with no significant loss of fairness by simply removing this provision.

4. Mandatory use of weighted average method of cost accounting for securities

a. The Discussion Draft’s Proposal

The proposal requires taxpayers to determine the basis of stock or bonds that are sold on or after January 1, 2014 by a single method: the average cost method. The proposal would eliminate FIFO and specific identification. However, the proposal requires a taxpayer to determine basis account-by-account, so taxpayers would retain selectivity if they hold lots of the same stock in different accounts. The goal of the proposal is “to simplify tax compliance and administration and to determine more accurately the amount of gain or loss when a security is sold.” As drafted, the average cost method would determine only the basis for sold securities; it would not create an average holding period for the sold securities (which presumably still would be determined on FIFO). The proposal applies to “specified securities,” which includes

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144 Regulation section 1.1012-1(e)(7)(ii), uses FIFO to determine holding period for shares when an average basis election applies.
stock (including mutual fund shares), debt, options, commodities and commodity derivatives contracts (to the extent the Treasury requires basis reporting for these contracts), and any other financial instruments for which the Treasury requires basis reporting. The proposal is effective for securities sold on or after January 1, 2014. However, a taxpayer must average separately the cost basis of stock or bonds that were acquired before January 1, 2014 and those that are acquired on or after January 1, 2014. In addition, as noted above, the proposal would apply the average cost method on an account-by-account basis.

b. Committee’s Comments

i. Should Taxpayers Be Required to Use a Single Basis Method?

Our tax laws always have required investors to use “cost” basis to calculate their gains and losses on sale of stock. In 1918, the Treasury first adopted the first-in, first out rule (“FIFO”) to determine the cost of stock. Under this rule, taxpayers generally must treat their earliest-acquired shares as sold first (i.e., FIFO). However, taxpayers may specify different shares (or lots) if they can “adequately” identify them on sale (the “specific identification” method). These basis rules also extend to bonds. For shares of a mutual fund (i.e., a regulated investment company), a taxpayer also may elect to report cost basis by using an average cost method, in addition to the FIFO or specific identification methods. To establish holding period for stock that has been sold, a taxpayer must use either FIFO (if FIFO or average cost has been used for basis) or specific identification (if specific identification has been used for basis). The holding period determines whether gain (or loss) is long or short-term.

Various sets of rules, including the wash sale rules and the bond discount and premium rules, adjust tax basis and holding period of stocks or bonds, which adds complexity to any cost basis method. Also, if a taxpayer receives stock or bonds by gift, the taxpayer must use a split cost basis on a sale—the taxpayer must use a carryover basis for gains, but the lower of carryover basis or fair market value of the stock at the time of gift for losses.

In 2008, Congress required brokers to report the cost basis from the sale of stock both to the customer and to the Service. The broker must also classify any gain or loss

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145 I.R.C. § 6045(g)(3)(B).
146 Sec. 113 of the Revenue Act of 1918, 40 Stat. 1057, provided fair market value as the basis for pre-1913 property and cost basis for property acquired after 1913.
147 A.R.R. 4837, III-1 CB 39.
148 Reg. § 1.1012-1(c)(1).
149 Reg. §§ 1.1012-1(c)(1)-(5).
150 Reg. § 1.1012-1(c)(6) (extends the stock lot selection rules to bonds).
151 Reg. § 1.1012-1(c).
152 For a history of the reporting provisions, see Steven M. Rosenthal, Basis Reporting: Lessons Learned and Direction Forward, 135 Tax Notes 353 (Apr. 16, 2012).
as long-term or short-term. The legislation acknowledged the complexity of reporting basis by staggering the effective dates for different types of securities. The cost basis reporting rules apply for the sale of stock acquired on or after January 1, 2011. For mutual fund shares (and certain stock acquired in a dividend reinvestment plan), the effective date is January 1, 2012, and for debt, options, and securities futures contracts, it is January 1, 2014. Treasury will determine the effective dates for other financial instruments later.

Under the cost basis reporting rules, brokers must follow an investor’s choice of basis methods. Investors may give standing instructions to their broker to determine the order in which stock is sold, or investors may accept the broker’s default choice. An investor also may elect an average cost method for mutual fund shares and dividend reinvestment plan shares.

Congress and Treasury adopted the rules for the cost basis of stock at a time when ownership of stock was represented by physical certificates, which were transferred on sale. In that context, a taxpayer might choose to deliver one share certificate over another. For example, suppose a taxpayer held two certificates, one representing 100 shares and the other representing 200 shares. A taxpayer that wanted to sell 100 shares might transfer the certificate for the smaller lot, rather than recertificate the larger lot. Today, the ownership of stock is recorded electronically and stock is completely fungible. As a result, any lot identification of stock is inherently artificial: there is little or nothing to distinguish one lot of shares from another in a meaningful way. In addition, most of those who participated in the drafting of this Report believe permitting a taxpayer to specify one lot of fungible property for sale over another is unduly formalistic. Our tax laws do not permit, for example, a manufacturer to select among fungible inventory items purchased at different times in order to determine the amount to subtract from gross receipts as the cost of goods sold. Rather, the manufacturer must use FIFO, LIFO, or, sometimes, a rolling-average inventory valuation, to match the costs of acquiring fungible inventory items against income from their disposition. These are “mechanical accounting conventions rather than item-by-item choices whose sole effect is to minimize taxes.”

However, as discussed above, taxpayers now may elect several different methods to calculate basis on the sale of securities, which can generate very different tax results.

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155 There may be small differences in holding shares through different accounts at different brokers, for example the level of insurance protection, or the size of brokerage fees, etc.
156 Reg. § 1.471-2(d) (“Goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices will be deemed to be the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired.”).
For mutual fund shares, taxpayers must now decide whether to (1) provide standing instructions to determine the order in which their shares should be sold (for example, highest basis first), (2) identify specific lots of shares to be sold at the time of sale, (3) elect average cost for their shares (separately for each of their accounts), and (4) revoke or change their standing instructions or elections.

As an example, suppose a taxpayer purchased 100 mutual fund shares at $10/share on February 1, 2012, 100 shares for $10.50 on April 1, 2012, and 100 shares for $11 on June 1, 2012. If the taxpayer sells 100 shares for $12/share on March 1, 2013, it could recognize $200 of gain on a FIFO basis, $150 on an average cost, or $100 on a specific identification basis (if it specified the last lot).

Some of members of the Committee believe that the existence of multiple choices gives taxpayers an unwarranted election to minimize or to continue to postpone the recognition of gain, undermines the simplicity of basis reporting, and confuses some taxpayers. Brokers (including mutual funds) must solicit and maintain customer basis choices, which a customer may change at designated times, and use that method to report. In practice, many investors simply accept the default determination. In addition, the multiple reporting methods diminish the Service’s ability to administer the tax rules effectively. With multiple methods, the difficulty of matching gains and losses from brokers’ basis reports with gains and losses reported on taxpayers’ income tax returns increases. As a result, some members of the Committee believe a single method would advance the Discussion Draft’s goal “to simplify tax compliance and administration.”

On the other hand, other members of the Committee believe taxpayer choice is an appropriate attribute of our income tax system, which allows taxpayers to plan and minimize their taxes. They believe broker reporting now alleviates much of the complexity of the alternative lot selection methods, at least for stock that is subject to the new reporting rules. Finally, they believe rewriting the basis rules would impose new burdens on reporting by brokers and mutual funds, which have incurred substantial costs to implement the current basis reporting regime.

ii. Should the Single Basis Method be Average Cost?

Many members of the Committee intuitively prefer an average cost basis for fungible property: if securities are fungible, their basis should be the same. However, we believe that the average cost method introduces many new technical problems. First, taxpayers still must determine whether gain or loss is long-term or short-term, which is done on a FIFO method under the Discussion Draft.\(^{158}\) We believe that a FIFO holding period rule combined with average basis can produce uneconomic results. For example, assume that a taxpayer owns two lots of XYZ stock, which is currently worth $100 per

\(^{158}\) FIFO is currently used to determine holding period for shares to which the average basis method applies (mutual fund shares and stock that is subject to a dividend reinvestment plan). Reg. § 1.1012-1(c)(7)(ii). In these instances, lots with a short-term holding period often are a result of reinvested dividends and are relatively small compared to the taxpayer’s overall investment, so the FIFO rule for holding period might be justifiable.
share. Lot 1 is 100 shares with a basis of $10 per share and a long-term holding period and Lot 2 is 100 shares with a basis of $100 per share and a short-term holding period. If the taxpayer sells the 200 shares for $100/share, the taxpayer would have total gain of $9,000, all of which, under present law, is attributable to Lot 1. But if the taxpayer used average cost to allocate between long-term and short-term gain, the taxpayer’s basis would be $55 per share— (total basis of $11,000 divided by 200 shares), so the taxpayer would have a long-term gain of $4,500 and a short term gain of $4,500. Effectively, the weighted average cost rule shifted basis from the new shares to the old shares, and thereby partially converted what is economically long-term capital gain into short-term capital gain.

The same phenomenon occurs with respect to losses, so a taxpayer who wants to convert long-term capital losses into short-term losses can buy additional shares of the same security and then immediately sell the new shares as well as the old ones. For example, assume a taxpayer owns 100 shares of ABC stock with a basis of $100 per share and a fair market value of $20 per share. If the taxpayer simply sells the shares, the taxpayer would have an $8,000 long-term capital loss. But if the taxpayer first buys an additional 900 shares at $20 per share and then sells all 1,000 shares for the same price per share, then the taxpayer would have the same $8,000 loss, but 90 percent of the loss would be short-term loss and only 10 percent would be long-term. To prevent this basis shifting, the taxpayer would need to separate shares with long-term holding periods from short-term, compute average cost for each pool, and treat any sale as coming proportionately from the long-term and short-term holdings. In our view, this complex approach would largely defeat the purported gains of simplicity and administration from an average cost basis rule.

Second, the basis of debt that is acquired at a premium or discount (either original issue discount or market discount) generally must be adjusted daily to reflect the daily amortization of the premium or discount (assuming current accrual). Applying these rules to average cost basis would make little economic sense and would overwhelm many taxpayers, as each new purchase would require new yield computations and amortization schedules. In addition, some proposals, such as the cap on maximum yield accrual discussed above in Part 3(d), are more naturally applied to separate debt lots rather than to a pool of debt having an average cost.

Third, gifts of stock raise special problems with average cost. That is because, to determine loss, the basis of the stock is limited to its fair market value at the time of the gift. Because of this limit, the average cost pool for mutual fund shares excludes gifted shares unless the taxpayer elects to limit basis to fair market value for all purposes. If

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159 See Reg. § 1.1272-1(g) (original issue discount); I.R.C. § 1278(b)(4) (market discount).
160 Furthermore, for bonds with stated interest, sales between bond payment dates include accrued interest, which currently must be determined on a bond by bond basis. A purchaser receiving the next interest payment excludes the accrued interest from income as a recovery of its investment. Substituting an average interest accrual rate to determine accrued interest could make uncertain both bond pricing and an investor’s calculation of its rate of return.
161 I.R.C. § 1015(a).
162 Reg. § 1.1012-1(e)(8).
the Discussion Draft’s proposal were adopted, a similar rule would be needed for other stock, which would add complexity to the basis determinations.

Fourth, under current law, a broker may only average mutual fund shares for which accurate basis information is available. Otherwise, one lot of shares with an inaccurate basis could taint the average pool calculation indefinitely. If an average basis proposal were adopted for all stock, this principle presumably would need to be applied to stock more generally, which would decrease the utility of the reports that investors would receive from their brokers.

Finally, we expect an average cost rule would increase investor confusion. For average cost, taxpayers must make additional calculations, with which their brokers might not assist (for example, brokers do not need to report basis for securities acquired before the effective date of the basis reporting rules). We understand that taxpayers might use computers, calculators, and tax software to help them calculate average cost, but we believe many taxpayers would be overwhelmed.

iii. What Should the Basis Method Be?

We believe FIFO is preferable to average cost for simplicity and administration. For almost a century, FIFO has been the default method to identify stock that has been sold, although some taxpayers have elected to specifically identify lots. Thus, if Congress chooses to limit methods to determine basis, Congress need only repeal the specific identification election (and would avoid the technical problems that are described above). Moreover, FIFO is also the method used to determine holding period, so FIFO would avoid the problem of inconsistent rules for holding period and basis purposes.

In addition, for mutual fund shares, the basis reporting rules now permit a taxpayer to shift from the average cost method to FIFO for stock sales going forward, and to use the average cost of the earlier acquired shares as the basis of these earlier shares. The new FIFO rule could follow this change of method easily.

As a policy matter, we believe that FIFO is attractive. The realization method of accounting allows taxpayers to defer recognition of gain on appreciated securities until a security has been sold or exchanged. This is a tax benefit that can be of significant value

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163 Reg. § 1.1012-1(e)(1)(ii)(stock for which accurate information is not available must be treated as held in a separate account).
164 Investors often would like to know their basis, and the amount of potential gain or loss, before a sale occurs. Brokers are required to report basis only when a sale occurs but may provide basis information in periodic account statements as a customer service.
165 In 1970, Treasury first permitted shareholders of mutual funds to use average basis, in order to facilitate basis reporting by mutual funds. At that time, data storage was relatively expensive, and average cost was much cheaper than FIFO to maintain (and report). However, today, data storage (and computer technology) is much cheaper, so the need to use average cost has been mitigated.
166 Reg. §§ 1.1012-1(e)(9)(iii)-(iv) (if the taxpayer does not revoke its average basis election when it changes its identification method, the basis of the stock after the change is its basis immediately before the change).
to a taxpayer. Accordingly, if a taxpayer disposes of some but not all of his shares, we
think an ordering rule that results in cutting off the deferral of recognition of gain on the
shares that have been held the longest is sensible. However, the FIFO rule may also
operate in the taxpayer’s favor; if a taxpayer had purchased multiple lots of stock in a
falling market, the FIFO rule would accelerate losses.

iv. Multiple accounts

Regardless of the lot selection rule adopted, most of the participants in the
drafting of these Comments believe that basis should be determined in an account-by-
account manner, at least for accounts held at different brokers. That approach would
permit an investor that holds the same stock in multiple accounts to use the basis and
holding period of the stock from the account in which the sale occurred, rather than the
basis of stock from a different account.

We believe a taxpayer’s use of separate accounts is consistent with the
simplification and administration goals. Brokers can only report transactions at accounts
maintained at their firms, not other firms. As a result of this consideration, current law
requires brokers to report basis to their customers account by account, which the
Committee members believe to have been immensely helpful (as customers generally
report the same basis to the Service). If Congress were to require customers to calculate
their basis across accounts, the basis reports provided by brokers frequently would be
useless.

We understand that determining basis by account preserves some taxpayer
flexibility. However, most of the participants in the drafting of these Comments believe
this selectivity would not significantly undercut the policy objectives of moving to a
single method of determining which shares have been sold. We doubt that many
taxpayers would choose to hold different lots of the same stock in different brokerage
accounts for the sole purpose of preserving the choice of which lots to sell in the future.

We understand that brokers are concerned that some of their customers might ask
to open multiple accounts, which they may fear could increase their administrative costs.
To address that concern, the proposal could require brokers to consolidate accounts for
the same taxpayer, thereby eliminating the planning opportunity. Of course, taxpayers
could respond to this by setting up differently registered accounts (e.g., as joint tenancies
with relatives), but we think taxpayers are unlikely to want to open a large number of
such accounts to avoid this consolidation rule. Some members of the Committee believe
that, although each broker should be permitted to determine basis for reporting purposes
without regard to a customer’s accounts held with other brokers, the substantive rule for
taxpayers should be that lots are deemed to be sold on a FIFO basis, without regard to the
account in which such shares were held. While such a rule would admittedly difficult to
police, we believe it would deter most taxpayers from setting up multiple accounts for the
purpose of avoiding the FIFO rule.
v. Effective Date

The proposal would be effective for securities sold on or after January 1, 2014. Thus, a taxpayer must use average cost (or, FIFO, if our recommendation is accepted) for every sale of stock or mutual fund shares on or after the January 1, 2014 effective date. As a transition rule, the proposal requires taxpayers to calculate separately their average cost for securities acquired before the January 1, 2014 effective date and securities acquired on or after the effective date (i.e., two baskets). While we support the idea behind the transition rule in having two baskets of securities, we believe the acquisition date for the baskets should link to the effective dates of broker basis reporting.

To ease the transition, we suggest taxpayers determine basis separately for stock acquired before January 1, 2011, on the one hand, and for stock acquired on or after that date, on the other hand (and, for mutual fund shares, before January 1, 2012, and on or after that date). Thus, the transition rule would separate out securities for which brokers have no record of their customers’ basis from those for which they do. As a result, taxpayers could receive help from their brokers for their sales on or after January 1, 2014 for a larger pool of securities. In addition, Congress could choose whether to require taxpayers to calculate average cost (or FIFO) on their own for stock that was purchased before January 1, 2011 (or mutual fund shares before January 1, 2012), or limit the new basis proposal to the second basket (i.e., securities for which brokers already are reporting basis).

5. Wash Sale Proposal

a. Discussion Draft Proposal

The wash sale rules of section 1091 prevent taxpayers from taking losses on sales of securities where substantially identical securities are purchased within the period beginning 30 days before and ending 30 days after the date of the sale at a loss (i.e., “the 61 day wash sale window”). The original rules, enacted in 1921, disallowed the loss without providing a specific mechanism to preserve the loss for later recognition. The 1921 Act suggested that the acquired securities had a substituted basis equal to that of the disposed securities, but only if the substantially identical securities were purchased for the same price as the securities sold. In 1924, a basis adjustment rule that more mechanically provided for deferral rather than disallowance was added, addressing the purchase of substantially identical securities at different prices and in different quantities (this “basis adjustment rule” is now set forth in section 1091(d)). In 1932, Congress provided for the tacking of the holding period of the securities sold onto the holding period of the securities acquired.

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167 Revenue Act of 1921, ch. 136, 42 Stat. 227, Sec. 214(a)(5); I.R.C. § 113(a)(10) (1939).
period of the substantially identical securities acquired for purposes of determining whether gain or loss is short-term or long-term.\textsuperscript{170}

The essence of the wash sale rule has remained unchanged since 1932, although the rule has been amended over time to expand and clarify its coverage to other financial instruments, including short sales, contracts to acquire securities, securities futures, and cash settled contracts. The wash sale rules do not apply to stock or securities dealers for losses sustained in the ordinary course of business. They also do not apply to stocks or securities that are marked to market under sections 475 or 1256,\textsuperscript{171} or to stock or securities that are positions in a straddle.\textsuperscript{172}

The wash sale rules do not include any specific provisions applying the rules to transactions among related parties such as husband and wife, owners and their controlled corporations, and parents and children. Instead, sales of securities at a loss to a related taxpayer are analyzed for potential disallowance under section 267, which, very generally, disallows a loss realized on a sale between certain related parties (e.g., husband and wife). Section 267 in its predecessor form (referred to herein as “predecessor section 267”) was enacted in 1934 and was substantially expanded in its scope and applicability in 1937.\textsuperscript{173} However, the application of predecessor section 267 to a transaction that might have been considered a wash sale if undertaken by a single taxpayer has been frequently litigated by taxpayers and the Service.\textsuperscript{174} It should be noted that section 267 does not apply a mechanical rule similar to the 61 day wash sale window and there is uncertainty and concern, based on the case law, regarding whether related party transactions that would be considered a wash sale if they were conducted by a single taxpayer are subject to disallowance under section 267. For instance, if a pair of related party sale-and-purchase transactions occurred outside of the 61 day wash sale window (e.g., a husband sells stock into the market on January 15, and the wife purchases the same stock from the market on February 20), could section 267 apply to disallow the loss? Unlike the wash sale rules, if section 267 applies, losses generally are disallowed rather than deferred.\textsuperscript{175}

In 1947 the Supreme Court held, in \textit{McWilliams v. Commissioner}, that predecessor section 267 applied to disallow losses where a husband sold stock from his

\textsuperscript{170} Revenue Act of 1932, ch. 209, 47 Stat. 169, Sec. 101(c)(8)(D). This provision is now found in section 1223(3).
\textsuperscript{171} See I.R.C. §§ 475(d)(1), 1256(f)(5).
\textsuperscript{172} See I.R.C. § 1092(b); Reg. § 1.1092-2(e).
\textsuperscript{173} Revenue Act of 1934, ch. 277, 48 Stat. 680, Sec. 24(a)(6); Revenue Act of 1937, ch. 815, 50 Stat. 813, Sec. 301(b)(1).
\textsuperscript{174} See, e.g. United States v. Norton, 250 F.2d 902 (5th Cir. 1958), Merritt v. Commissioner, 400 F.2d 417 (5th Cir. 1968).
\textsuperscript{175} Section 267(d) provides that, in a sale or exchange of property acquired from a related party where a loss was previously disallowed, the related party transferee, upon a subsequent sale or other disposition of such property (or other property which basis is determined from the basis of such property), only recognizes gain in excess of the disallowed loss allocable to the property. This rule only applies in cases of recognized gain rather than loss on such subsequent sale. Moreover, the last sentence of section 267(d) provides that this “excess gain” rule is not applicable “if the loss sustained by the transferor is not allowable to the transferor as a deduction by reason of section 1091 (relating to wash sales)...”
accounts at a loss and instructed his broker to purchase stock for his wife’s accounts, where his stated purpose was to establish tax losses. This decision settled questions about the applicability of section 267 in transactions similar to wash sales involving related parties. However, it did not and could not address questions about the precise application of the wash sale rule in the related party context (including the appropriate time period between a sale and a purchase by a related party, such as whether there was a period comparable to the 61 day wash sale window) or its application in a variety of other related party situations. As a result, litigation under section 267 in cases similar to wash sales has continued long after McWilliams.

In 2007, the Service issued Revenue Ruling 2008-5, which applied the wash sale rule (and not section 267) in the case of a taxpayer who sold stock from a taxable account at a loss while the taxpayer’s individual retirement account (IRA or Roth IRA) purchased substantially identical stock at market value. Both IRAs and Roth IRAs are organized and treated as separate legal entities in the form of trusts, which are distinct from their contributors/beneficiaries. Section 267 does not by its terms explicitly include retirement trusts as related persons. In Revenue Ruling 2008-5, the Service did not refer to section 267 but instead analyzed the transaction strictly under the wash sale rules. It concluded that the IRA was treated as if it were the taxpayer, based on the reasoning of the Board of Tax Appeals in Security First National Bank v. Commissioner, and ruled therefore that the wash sale rules applied and the taxpayer’s loss was disallowed. The Service further ruled that the basis adjustment rule of section 1091(d) did not apply so that the IRA was not entitled to a basis adjustment on the acquired securities. As a result, the Service essentially concluded that the taxpayer’s loss was disallowed, rather than deferred—a result that is clearly contrary to the explicit basis adjustment rule of section 1091(d).

The Discussion Draft would amend the wash sale rules to explicitly provide for their application to acquisitions of substantially identical stock or securities by the taxpayer or a related party. Related party would be explicitly defined in new section 1091(g). The Discussion Draft also would permanently disallow losses in the case of any acquisition by a related party other than the taxpayer’s spouse by prohibiting a basis adjustment for the purchased substantially identical stock or security.

Under the Discussion Draft, for purposes of the wash sale rules, a related party means: (1) the taxpayer's spouse; (2) any dependent of the taxpayer and any other

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176 McWilliams v. Commissioner, 331 U.S. 694 (1947).
177 See, e.g., United States v. Norton, 250 F.2d 902 (5th Cir. 1958) (where son sold stock and mother purchased on same day, loss disallowed under predecessor of section 267; where son sold stock and mother purchased 28 days later, loss allowed under such predecessor) and Merritt v. Commissioner, 400 F.2d 417 (5th Cir. 1968) (involuntary sale of stock from husband to wife triggered loss disallowance under section 267).
179 I.R.C. § 267(b)(6) would not apply if the taxpayer is not considered the fiduciary.
181 Prop. I.R.C. § 422(a). The Discussion Draft provides that the amendments set forth in Sec. 422 would apply to sales and other dispositions occurring after December 31, 2013.
taxpayer with respect to whom the taxpayer is a dependent; (3) any individual, corporation, partnership, trust, or estate that controls, or is controlled by the taxpayer or any individual described in (1) or (2); (4) any individual retirement arrangement ("IRA"), Archer MSA, or health savings account of the taxpayer or of any individual described in (1) or (2); (5) any account under a qualified tuition program or a Coverdell education savings account if the taxpayer or any individual described in (1) or (2) is the designated beneficiary of such account or has the right to make any decision with respect to the investment of any amount in such account; and (6) any account under a qualified retirement plan, qualified annuity plan, tax-sheltered annuity plan, or governmental eligible deferred compensation plan, if the taxpayer or any individual described in (1) or (2) with respect to the taxpayer has the right to make any decision with respect to the investment of any amount in such account.

The Discussion Draft also includes rules stating that most relationships are determined as of the time of the acquisition of substantially identical stock or securities.\(^{184}\) Spousal and dependency relationships are determined for the taxable year which includes such purchase or exchange. Marital status is determined under section 7703, unless a husband and wife file separate returns for any taxable year and live apart at all times during such taxable year, in which case they shall not be treated as married individuals for purposes of the wash sale rules.\(^{185}\)

b. Committee Comments on Discussion Draft Proposal

By amending section 1091 to explicitly apply to related parties and including retirement accounts as related parties, the Discussion Draft would presumably prevent or reduce future litigation regarding the scope and application of the wash sale rule in the related party context. In addition, the Discussion Draft essentially codifies the holding of Revenue Ruling 2008-5, which is desirable given the uncertainty as to whether the ruling is correct—both with regard to the applicability of section 1091 in its present form to transactions involving both a taxpayer and his or her IRA and with regard to the appropriateness of disallowing the loss by denying a basis adjustment mandated by section 1091(d).

We agree that the application of the wash sale rules to related parties, including retirement accounts, is sensible tax policy. However, if the wash sale rules were expanded to apply to related parties, section 267 should not override or otherwise disallow losses that are permitted with respect to the sale of stocks or securities in the open market that are not covered under the expanded wash sale rules.\(^{186}\) As an alternative to an expanded wash sale rule, Congress might consider (1) extending section 267(a)(1) to treat an IRA, Roth IRA or another tax-deferred vehicle as a related person under

\(^{184}\) Prop. I.R.C. § 422(c).

\(^{185}\) Prop. I.R.C. § 422(a).

\(^{186}\) As a side note, because the basic rule under section 267 of disallowance other than in the case of subsequent sales at a gain pursuant to section 267(d) appears harsh, many members of the Committee advocated that section 267(d) be revised more broadly to provide generally for deferral rather than disallowance. We recommend that such a revision be considered in connection with any proposals to update or amend section 267.
section 267(b) and (2) defining circumstances under which a sale by a taxpayer and a
purchase by a related party within the 61 day wash sale window would be treated as an
indirect sale by the taxpayer to the related party.

We disagree with the Discussion Draft’s proposal to disallow (by way of its
amendment of section 1091(d)) rather than defer losses pursuant to present section
1091(d) as is ordinarily the case with respect to wash sales. The underlying principle of
the wash sale rule is that a taxpayer should not be allowed to recognize a loss by selling
securities if the taxpayer essentially has not changed his or her economically long
position with respect to such securities (section 1091(e) applies the same concept to short
positions). The current rule of deferral and recognition of the loss when the substantially
identical securities are sold is consistent with this underlying principle because upon such
subsequent disposition the taxpayer is no longer economically long such securities.
Section 1091(d), through the specified basis adjustment to the acquired securities
triggering the wash sale, accomplishes this subsequent recognition of the deferred loss. In
the context of related parties, the same deferral, rather than disallowance, principle
should apply.

We do not agree that deferral in the related party context should only be permitted
if the related party is the taxpayer’s spouse. There is no justifiable policy for imposing
disallowances, rather than deferral, of a loss when a taxpayer sells a security and a related
party purchases the same security within the wash sale window. Consequently, we
believe that it is unreasonable to penalize the taxpayer by requiring disallowance of the
wash sale loss in the context of a related party purchase, regardless of whether the related
party is the taxpayer’s spouse.

We are concerned that the mechanics of the basis adjustment rule of section
1091(d) are unnecessarily complicated when purchases by related parties occur. In
addition, adjusting the purchaser’s basis to account for a related seller’s unrecognized
loss allows a clear opportunity to shift losses from a low-tax rate or zero-tax rate taxpayer
to a higher-tax rate taxpayer.\(^{187}\) Accordingly, we believe that the taxpayer that sold the
security at a loss that was deferred due to a related party purchase of a replacement
security should be entitled to recognize the deferred loss in the tax year that the related
party disposes of the substantially identical stock that triggered the wash sale deferral.\(^{188}\)

We believe that section 1223(3) should be modified so that the holding period of
securities sold at a loss that are subject to the wash loss rules is not tacked onto the
holding period of the substantially identical securities acquired by a related party because
of tracking complexities similar to those we believe arise with making basis adjustments
for wash sales to such substantially identical securities. Instead, we recommend that the

\(^{187}\) We understand that, particularly in the case of tax-deferral or tax-free vehicles that are controlled by
the taxpayer, such as IRAs, Roth IRAs, Archer MSAs, health savings accounts and the like, the public may
perceive a taxpayer’s sale at a loss paired with an acquisition by a related taxpayer with a lower or zero tax
rate as avoiding tax on expected future gain. In appropriate and narrowly drawn circumstances, a
disallowance rule may be acceptable.

\(^{188}\) We are not recommending that the existing basis adjustment rule of section 1091(d) be replaced with a
similar deferral rule because many of our members believe it would be more complex.
long-term/short-term character of the deferred loss that should be recognized by the taxpayer upon disposition by a related party of the substantially identical securities that resulted in a wash sale should take into account the related party’s holding period for such substantially identical securities.

We note that there are at least two technical issues that are not specifically addressed by the Discussion Draft that we believe are raised by the proposed revision of the wash sale rules. First, we believe that an ordering rule should be included so that wash sales within the taxpayer’s own account are determined and applied before wash sales occurring due to purchases by related parties. Second, we believe that consideration should be given to conforming the related party rules in sections 267 and 1092 to the version set forth in the Discussion Draft by adding references to retirement trusts.