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Client Alert

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Tax Reform Act of 2014—Derivatives, Hedges and Other Financial Product and Securitization Relevant Provisions

Federal income tax reform has been the subject of numerous congressional talking points and committee hearings over the last year. On February 26, 2014, Representative David Camp, chair of the House Ways and Means Committee, released draft legislation referred to as the Tax Reform Act of 2014 that proposes to amend major portions of the Internal Revenue Code to provide for comprehensive tax reform. An overarching goal of the proposed legislation is to reduce both corporate and individual tax rates to 25% or less and to pay for those rate reductions by eliminating many tax breaks.

The following is a summary of the proposed changes related to derivatives, hedges, other financial products and securitization. We have also prepared summaries of other provisions relevant to other topical areas—please check our website for those. Although the Tax Reform Act of 2014 has not yet been formally introduced as a bill, and its prospects for passage are uncertain at this point, given the significant nature of the proposed reforms, we will monitor their progress and provide updates as warranted.

Derivatives

The proposal would require taxpayers to mark derivative contracts to market, recognizing accrued gains or losses as if a derivative were sold as of the end of each taxable year. Such gain or loss would be treated as ordinary in character (and not as capital gain or loss). Derivatives broadly include any contract—including options, forwards, futures, short positions, swaps or similar contracts—which reference either specified property (including stock, partnership or trust interests, debt, and certain interests in real property), foreign currency, or "any rate, price amount, index, formula, or algorithm." The proposal generally would not require stock or debt to be marked to market. However, if a taxpayer has a straddle consisting of a derivative and a non-derivative offsetting position—including a position in debt other than certain "straight" debt, or stock which is not part of a "qualified covered call"—both the derivative and the non-derivative position must be marked to market. Upon entering into such a straddle, the taxpayer also must recognize any built-in gain (but defer any built-in loss) in the non-derivative position (although pre-straddle accrued gain may be treated as capital). The proposal would exclude certain hedging transactions, securities lending and "repo" contracts, compensatory options, and certain other specified contracts from its application.

This mark-to-market proposal would allow for repeal of many existing financial instrument provisions—including various rules relating to short sales, options, contract terminations, futures and section 1256 contracts, conversion transactions, and constructive sale and ownership transactions. This simplification is made possible in large part because, unlike certain similar, predecessor mark-to-market proposals, the proposal would not be limited to derivatives that are (or that reference positions which are) actively or publicly traded. Apart from raising issues of increased breadth, not to mention taxpayer liquidity (to pay tax on accrued gains), such an approach suggests potentially difficult valuation issues in the many situations where it may apply.

The proposal also addresses contracts with embedded derivative components, treating each component as a separate derivative if it can separately be valued—essentially imposing bifurcation, historically rare under the tax law. Although the proposal excludes certain debt instruments from this bifurcation of embedded derivatives—among them, debt denominated in (or referencing) a foreign currency, as well as convertible, contingent and variable rate debt—the proposal would direct Treasury to write rules subjecting convertible debt to the contingent payment debt rules, a sea change in their longstanding tax treatment as straight debt whose option value generally was ignored, rather than creating original issue discount subject to current accrual.

According to the proposal, the derivatives provisions would increase revenue by $15.7 billion between 2014 and 2023—a substantial sum, perhaps suggesting heightened likelihood that they will appear in some legislative vehicle at some point, whether tax reform or elsewhere.

Business Hedging

Under the proposal, a hedging transaction—*i.e.*, a transaction entered into to manage business risk relating to ordinary assets or liabilities—would be treated as meeting applicable identification requirements not only if identified as required under existing law, but also if treated as a hedging transaction within the meaning of GAAP for purposes of specified audited and certified financial statements. Separately, the proposal would treat debt held by an insurance company as ordinary property for purposes of determining the availability of hedging treatment with respect to the debt, addressing a longstanding character mismatch issue faced by insurers.

Market Discount

The proposal would mandate current inclusion of market discount on debt acquired after December 31, 2014 on a constant yield basis, much like the accrual of original issue discount, rather than requiring inclusion only upon disposition or receipt of principal payments as under current law. The amount so included would be limited, however, so as not to require income inclusion (together with stated interest and original issue discount) exceeding a maximum accrual rate—equal to the greater of (i) original yield to maturity plus five percent or (ii) a specified comparable Treasury rate plus ten percent. The market discount provisions of present law—*e.g.*, the rules deferring interest expense incurred to purchase or carry market discount bonds, or those treating gain on disposition as ordinary to the extent of accrued market discount—would not apply to debt subject to these proposed rules. In that vein, gain or loss on the sale or exchange of a market discount bond held as a capital asset would be capital gain or loss, except that loss would be ordinary to the extent market discount previously had been included in income (addressing the character mismatch between ordinary market discount accruals and capital loss attributable to corresponding basis additions). The provision would also add information reporting requirements (applicable to brokers and other persons transferring "covered bonds" subject to the proposed rules) with respect to a bondholder's market discount accruals.

Debt Exchanges and Modifications

The proposal would modify rules relating to debt modifications and exchanges, mitigating some of the effects to issuers and holders in modifying distressed debt. Generally, modifications or exchanges that do not reduce the principal amount would not trigger cancellation of indebtedness income to the issuer, regardless of value of the debt or whether it was publicly traded. Holders would recognize gain only to the extent property other than debt of the issuer was received in the modification or exchange—and would not recognize any loss, until actually disposing of the new debt, even where principal had been reduced.

Tax Basis Using FIFO and Not Specific Identification

Under the proposal, taxpayers would no longer be allowed to specifically identify stock (or other specified assets) sold for purposes of determining gain or loss, but generally would be required to determine gain or loss on a first-in, first-out (FIFO) basis. Existing law allowing average cost basis accounting for sales of mutual fund stock would be preserved.

Wash Sales

The proposal would create a rule disallowing losses in wash sales by related parties; unlike the current rules, however, the proposal generally would result in complete disallowance (rather than deferral) of loss in related party wash sales.

Derivatives With Respect to a Corporation's Own Stock

Under the proposal, a corporation generally would not recognize income, gain, loss or deduction with respect to a derivative relating to its own stock—except for certain forward contracts entered into to acquire its own stock (as to which the excess of the amounts received over the value of the stock would be accounted for as OID).

Repeal of Publicly Traded Partnership Exception for Investment Partnerships

Under current law, "publicly traded" partnerships ("PTPs") engaging in financial activity avoid classification as corporations for tax purposes if they earn sufficient "qualifying income," generally including certain specified investment income. Seeking to end this avoidance of corporate taxation by large financial firms, the proposal would repeal this exception from corporate classification (except as it applies to mining and natural resource income). It is not clear that this proposal was intended to affect investment partnerships and securitization vehicles more generally, although it seems to do so—even those not engaged in any significant or active business activity whatsoever. According to the Joint Committee on Taxation, this provision would increase revenue by $4.3 billion from 2014 through 2023—again perhaps suggesting its likely appearance in some legislative vehicle at some future point.

To the extent that any part of this summary is interpreted as being tax advice, (i) no taxpayer may rely upon this summary for the purposes of avoiding penalties, (ii) this summary may be interpreted for tax purposes as being prepared in connection with the promotion of the transactions described, and (iii) taxpayers should consult independent tax advisors.

For More Information

To discuss any of the topics covered in this Client Alert, please contact Colman Burke, Paul Carman, Melanie Gnazzo, or any other member of the Tax Department, or visit us online at Chapman.com.