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MAY 18 2016

Honorable Ron Wyden
United States Senate
SD-221
Washington, D.C. 20510

Dear Senator Wyden:

This letter is in response to your request for a technical explanation of your discussion draft to modernize the tax treatment of derivatives and their underlying investments, and for other purposes, the "Modernization of Derivatives Tax Act of 2016." The enclosed document, prepared by the staff of the Joint Committee on Taxation, provides such technical explanation.

I hope this information is helpful to you. If we can be of further assistance in this matter, please let me know.

Sincerely,

Thomas A. Barthold

Thomas A. Barthold

Enclosure

cc: Adam Carasso
Todd Metcalf
Tiffany Smith

DESCRIPTION OF THE MODERNIZATION OF DERIVATIVES TAX ACT OF 2016[1]

Present Law

In general

A derivative is a contract in which the amount of at least one contractual payment is calculated by reference to the change in value of something (or a combination of things) that is fixed only after the contract is entered into. The thing that fixes the payment amount(s) and the derivative's value is called an "underlying," examples of which include assets, liabilities, indices, and events. The most common forms of derivative are options, forwards, futures, and swaps. The taxation of derivatives has developed over a long period of time without a consistent underlying policy. The tax rules apply differently depending on the form of the derivative, the type of taxpayer entering into it, the purpose of the transaction, and other factors. The rules are complex and may be uncertain in their application. There may be no connection between the economic effects to a taxpayer of entering into a derivative and the tax rules that result from that activity.

Following is a discussion of the features of the most common derivative contracts, and the general timing, character, and source rules under current law. The rules for timing and character may be different depending on the type of taxpayer entering into the derivative (for example, a dealer in securities[2]), on the use of the derivative (for example, as a hedge[3]), the underlying, the type of derivative (for example, whether it is traded on a U.S. exchange), or the application of other overriding rules (for example, the straddle rules[4]).

Options

An option is a derivative in which one party purchases either the right to deliver or right to receive a specified thing to or from another party on a fixed date or during a fixed period of time, in exchange for a payment whose value is fixed when the contract is entered into. The purchaser of the option is also called the holder; the seller of the option is also called the writer or issuer. When the option purchaser gives or receives the specified thing to the other party in exchange for the payment, the purchaser is said to exercise its right. The latest time the purchaser can exercise its right is called the expiration date. The thing that is delivered or that fixes the amount of payment at the expiration date is called the underlying. The payment by the

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[1] This document provides a description of the Modernization of Derivatives Tax Act of 2016, a discussion draft prepared by Senate Committee on Finance Ranking Member's Wyden's staff to modernize the tax treatment of derivatives and their underlying investments, and for other purposes, released May 18, 2016 ("MODA" or the "discussion draft").

[2] Under sec. 475. Unless otherwise stated, all section references are to the Internal Revenue Code of 1986 ("the Code"), as amended.

[3] Under sec. 1221(a)(7).

[4] Under sec. 1092.

purchaser for the option is called the premium, and the payment made for the thing at expiration is called the strike price. A European-style option is an option that can only be exercised at the expiration date. An American-style option is an option that can be exercised at any time prior to the expiration date.

A call option is an option in which the option purchaser has the right to buy a specified thing. A put option is an option in which the option purchaser has the right to sell a specified thing. Payment at the expiration date can take many forms. An option is called "physically settled" when the underlying is delivered from one party to the other. An option is called "cash settled" when one party pays cash equal to the difference between the strike price and the value of the underlying at the expiration date.

In general,[5] no tax consequences are recognized upon entering into an option contract, even though option premiums are paid without any possibility for recovery or return. The option purchaser's premium payment is nondeductible, and the option seller does not include the premium payment in income.[6] For the purchaser of a put option, if the option is exercised, the premium reduces the amount received in the sale of the underlying. For the purchaser of a call option, if the option is exercised, the premium becomes part of the basis in the property acquired.

For an option purchaser, gain or loss attributable to the sale or exchange, or loss from failure to exercise an option, is considered gain or loss from property of the same character as the option's underlying.[7] A seller of an option has ordinary income if the option is not exercised,[8] but if the option is with respect to "property," any gain or loss from closing or lapse is short-term capital gain or loss.[9] For this purpose, "property" includes stocks, securities, commodities, and commodity futures.[10] If an option purchaser exercises a cash settled option, then gain or loss is short-term or long-term depending on whether the option purchaser has held the option for more than one year.[11] If an option purchaser exercises a physically settled option, the holding period for the property delivered is calculated from the date the option is exercised.[12] Option purchasers

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[5] This discussion does not address options granted in connection with the performance of services.

[6] Rev. Rul. 78-182, 1978-1 C.B. 265. Courts decided receipt of option premiums were nontaxable because it could not be determined if the premiums were gain or return of capital until expiration. *Virginia Iron Coal & Coke Co. v. Commissioner*, 37 BTA 195 (1938), aff'd, 99 F2d 919 (4th Cir. 1938), cert. denied, 307 US 630 (1939).

[7] Sec. 1234(a)(1).

[8] Treas. Reg. sec. 1.1234-1(b).

[9] Sec. 1234(b).

[10] Sec. 1234(b)(2)(B).

[11] Rev. Rul. 88-31, 1988-1 C.B. 302.

[12] *Ibid.* The new holding period begins on the day the option is exercised if the underlying is stock or other securities acquired from the corporation that issued the securities. Sec. 1223(5). Otherwise, the holding period begins the day after the option is exercised. *Weir v. Commissioner*, 10 T.C. 996 (1948), aff'd, 173 F.2d 222 (3d Cir. 1949).

may be treated differently depending on whether they hold cash settled or physically settled options, even though their economic positions may be similar.

The source of income from the sale of personal property generally follows the residence of the taxpayer.[13] Specific authority is provided in section 865(j)(2) for the Secretary[14] to write regulations for sourcing of income from trading in futures contracts, forward contracts, options contracts, and other instruments. Guidance governing the source of payments on option payments has not been published. Practitioners have argued that gains on option contracts should be sourced to the residence of the person receiving the gain, and analogous rules should apply to losses.[15]

Forwards

A forward is a derivative in which one party agrees to deliver a specified thing to another party on a fixed date in exchange for a payment whose value is fixed when the contract is entered into. The party agreeing to deliver the thing is called the short party; the party agreeing to pay is called the long party. The date on which the short party must deliver is called the delivery or expiration date. The thing that is delivered or that fixes the amount of payment at the expiration date is called the underlying. The payment by the long party at delivery is called the forward price. For most forwards, no payment is made when the contract is signed. In a prepaid forward, the long party pays the short party the forward price (discounted to present value on the date of the payment) at the time the parties enter into the contract.[16] A variable forward requires the short party to deliver an amount of property that varies according to a formula agreed to when the contract is signed.[17]

A forward is called "physically settled" if the underlying is delivered from one party to the other. A forward is called "cash settled" if one party pays cash equal to the difference between the forward price and the value of the underlying on the delivery date.

The terms "forward" and "futures contract" have distinct meanings in the tax law, and those meanings do not necessarily coincide with how the terms are used for regulatory purposes, or in common parlance. In the tax law, a futures contract is a subset of forwards that is traded on a regulated U.S. exchange. The taxation of futures contracts is discussed under the heading "Mark to market," below.

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[13] Sec. 865(a). Other rules override this residence-based source rule for some kinds of gains, such as income from the sale of inventory property. See, for example, sec. 865(b).

[14] Unless otherwise noted, any reference to the "Secretary" means the Secretary of the Treasury.

[15] Michael J. Feder, *Practical Guide to the Taxation of Financial Transactions*, CCH 2011, p. 182, fn. 21.

[16] See Notice 2008-2, 2008-1 C.B. 252, December 7, 2007.

[17] See, for example, *Anschutz Co. v. Commissioner*, 135 T.C. 78 (2010), aff'd, 664 F.3d 313 (10th Cir. 2011).

In general, no tax consequences are recognized on entering into a forward.[18] If a forward is physically settled, the short party recognizes gain or loss in the amount of the difference between the forward price and the short party's basis in the property in the year in which the delivery takes place.[19] The long party reflects the forward price as the basis in the property acquired; any gain or loss is deferred until a subsequent realization event.

In general, the character of the gain or loss with respect to a forward is the same as the character of the property delivered.[20] Gain or loss on the sale or exchange of a forward is long term capital gain or loss if the contract has been held for longer than the requisite holding period.[21] Cash settlement of a forward is treated as a sale or exchange.[22]

If a forward qualifies as a commodity futures contract not subject to section 1256, the long party's holding period on the underlying includes the period in which the party held the forward contract.[23] For other physically settled forwards, the holding period of the underlying begins when the burdens and benefits of ownership are transferred from the short party to the long party.[24] For short parties to physically settled securities forwards and commodities futures, section 1233 and the accompanying regulations provide rules regarding holding periods,[25] although these rules have been partly supplanted by section 1234B (governing certain securities

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[18] If, however, the forward buyer obtains possession of the underlying property prior to the delivery date specified in the contract, the transaction may be considered "closed" for tax purposes, and the transfer of possession may be treated as a realization event. See, for example, *Commissioner v. Union P. R. Co.*, 86 F.2d 637 (2d Cir. 1936) and *Merrill v. Commissioner*, 40 T.C. 66 (1963).

[19] Sec. 1001.

[20] Sec. 1234A and Prop. Treas. Reg. sec. 1.1234A-1(c)(1).

[21] *Carborundum Co. v. Commissioner*, 74 T.C. 730, 733-42 (1980); *American Home Products Corp. v. United States*, 220 Ct. Cl. 369, 383-87 (Ct. Cl. 1979); *Hoover Co. v. Commissioner*, 72 T.C. 206, 250 (1979), nonacq., 1980-2 C.B. 2.

[22] *Estate of Israel v. Commissioner*, 108 T.C. 208, 217 (1997).

[23] Sec. 1223(7); see also Treas. Reg. sec. 1.1223-1(h). If the contract is physically settled and section 1256 does apply, then the taxpayer's holding period begins on the delivery date and does not include the prior period during which the taxpayer held the contract. Sec. 1256(c).

[24] Rev. Rul. 69-93, 1969-1 C.B. 139. In a case involving a physically settled forward for the sale of convertible debentures, one court held that the long party's holding period with respect to the debentures did not begin until delivery of the underlying debentures where: (1) the short party continued to receive interest payments on the debentures while the forward was open; (2) the short party was free to sell the debentures while the contract was open (provided that the short party delivered substantially identical property on the delivery date); and (3) the short party was free to use the debentures as security for other financial transactions. *Stanley v. United States*, 436 F. Supp. 581, 583 (N.D. Miss. 1977).

[25] Although the statutory text of section 1233 only makes reference to "short sales," the accompanying regulations indicate that section 1233 applies to forward contracts as well. See Treas. Reg. sec. 1.1233-1(c)(6) (example 6); see also *Hoover Co. v. Commissioner*, 72 T.C. 206, 249 (1979) (applying section 1233 to certain forward contracts).

futures contracts) and section 1256 (governing regulated commodities futures contracts). For transactions to which section 1233 still applies, a short party that physically delivers property to close a contract recognizes capital gain or loss on the transaction as short term or long term depending on the period for which the short party holds the property prior to delivery.[26] If a short party closes out a physically settled contract by purchasing the underlying asset and immediately delivering it to fulfill its contractual obligations, any capital gain or loss to the short party is short term capital gain or loss.[27]

Forwards for the sale of a single security or a narrow-based security index[28] are subject to a separate regime under section 1234B. Gain or loss attributable to the sale, exchange, or termination of a securities futures contract is considered gain or loss from the sale or exchange of property that has the same character as the property to which the contract relates has (or would have) in the taxpayer's hands. Section 1234B also provides that gain or loss on a securities futures contract, if capital, is treated as short term capital gain or loss regardless of the taxpayer's holding period.

The source of income from the sale of personal property follows the residence of the taxpayer.[29] Specific authority is provided in section 865(j)(2) for the Secretary to write regulations for sourcing of income from trading in futures contracts, forward contracts, options contracts, and other instruments. Guidance governing the source of payments on forwards has not been published. Practitioners have argued that income from a forward contract should be sourced to the residence of the person receiving the gain, and analogous rules should apply to losses.[30]

Swaps and notional principal contracts

"Notional principal contract" is the term in the tax law that is closest to what is colloquially known as a "swap." The tax term covers a narrower range of contracts than the colloquial term.[31] Treasury regulations define a notional principal contract as a financial

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[26] Sec. 1233.

[27] General Counsel Memorandum 39304, November 5, 1984.

[28] The term "narrow-based security index" includes indexes with nine or fewer component securities, indexes that are heavily weighted toward a small number of component securities, or indexes weighted toward securities with low trading volumes. 15 U.S.C. sec. 78c(a)(55). An option on a broad-based security index is treated as a nonequity option and is subject to section 1256.

[29] Sec. 865(a). Other rules override this residence-based source rule for some kinds of gains, such as income from the sale of inventory property. See, for example, sec. 865(b).

[30] Michael J. Feder, *Practical Guide to the Taxation of Financial Transactions*, CCH 2011, p. 143 fn. 29.

[31] A bullet swap – a swap with one payment only at the maturity of the contract – is included within the popular use of the term "swap." Whether it constitutes a notional principal contract under current law is uncertain. For a discussion of bullet swaps, see Joint Committee on Taxation, *Present Law and Issues Related to the Taxation of Financial Instruments and Products* (JCX-56-11), December 2, 2011, fn. 134.

instrument that provides for the payment of amounts by one party to another party at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.[32] A specified index is defined as a fixed rate, price, or amount that must be based on objective financial information not in control of either party.[33] A notional principal amount is defined as a specified amount of money or property that, when multiplied by a specified index, measures a party's rights and obligations under the contract but is not borrowed or loaned between the parties.[34]

Examples of notional principal contracts include interest rate swaps, currency swaps, and equity swaps.[35] Treasury regulations exclude certain instruments from the definition of notional principal contract including: (1) section 1256 contracts, (2) futures contracts, (3) forwards, (4) options, and (5) instruments or contracts that constitute indebtedness for Federal tax purposes.

For purposes of calculating the inclusion of income or expense flowing from a notional principal contract, the regulations divide payments exchanged by the parties to the notional principal contract into: (1) periodic payments (made at least annually); (2) termination payments (made at the end of the contract's life); and (3) nonperiodic payments (neither (1) nor (2)).[36] Taxpayers must recognize periodic and nonperiodic payments using a specified accrual method for the taxable year to which the payment relates, and must recognize a termination payment in the year the notional principal contract is extinguished, assigned, or terminated.[37] A swap with a nonperiodic payment is treated as two transactions: an on-market level payment swap and a loan.[38] The loan must be accounted for independently of the swap. Treasury regulations

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[32] Treas. Reg. sec. 1.446-3(c)(1)(i). Proposed regulations published in the *Federal Register* on September 16, 2011 (REG-111283-11) revise the definition of notional principal contract as follows. "A notional principal contract is a financial instrument that requires one party to make two or more payments to the counterparty at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts." Prop. Treas. Reg. sec. 1.446-3(c)(1)(i). A definition of payment is provided in these proposed regulations that has no parallel in the existing Treasury regulations. "[A] payment includes an amount that is fixed on one date and paid or otherwise taken into account on a later date." Prop. Treas. Reg. sec. 1.446-3(c)(1)(ii). The bullet swap described in the footnote immediately above might come within the definition of notional principal contract under the proposed regulations, although it is unclear how the proposed regulations would be operationalized if finalized in their current form.

[33] Treas. Reg. sec. 1.446-3(c)(2) and (4).

[34] Treas. Reg. sec. 1.446-3(c)(3).

[35] *Ibid.*

[36] Treas. Reg. sec. 1.446-3(e), (f) and (h).

[37] *Ibid.*

[38] Treas. Reg. sec. 1.446-3T(g)(4). Temporary and proposed regulations provide that the loan component that is in a nonperiodic payment is to be taxed as a loan regardless of its size. This is a change from prior law in which the loan was only treated as such if it was "significant." There are two exceptions under the Temporary regulations: (1) a nonperiodic payment made under a notional principal contract with a term of one year or less; (2) notional principal contracts with nonperiodic payments subject to certain margin or collateral requirements.

proposed in 2004 (the "2004 proposed regulations") provide that contingent nonperiodic payments (such as a single payment at termination tied to the change in value of the underlying) are accrued over the life of the swap based on an estimate of the amount of the payment.[39] The amount of a taxpayer's accrual is redetermined periodically as more information becomes available.[40]

Final Treasury regulations do not address the character of notional principal contract payments. However, regulations proposed in 2004 under section 1234A provide that any periodic or nonperiodic payment generally constitutes ordinary income or expense.[41] The preamble to the 2004 proposed regulations explains that ordinary income treatment is appropriate because neither periodic nor nonperiodic payments results from the sale or other disposition of a capital asset. The 2004 proposed regulations provide that gain or loss attributable to the termination of a notional principal contract is capital if the contract is a capital asset to the taxpayer but the regulations do not specify whether a taxpayer who holds a notional principal contract for more than one year should recognize capital gain or loss on account of a termination payment as short term or long term. The proposed regulations do provide that final settlement payments with respect to a notional principal contract are not termination payments under section 1234A.[42]

Securities and commodities dealers and traders

Special tax rules apply to dealers and traders in securities and commodities.

Dealers in the financial industry are of two types: those that hold inventories and those that do not. Dealers that hold inventory intend to make a profit from the difference between the price they buy their inventory for and what they sell it for; the difference is called a mark-up. Because financial inventory often trades in volatile markets, changes in market prices can have a significant impact on the profits a dealer makes.

Dealers that do not hold inventory are those that offer to enter into or otherwise transact in derivatives with customers. The profits of these dealers derive from fees charged to customers and from the spread between taking both sides of a derivative position.

Before 1993, dealers in securities could elect to account for their inventories under: (a) lower of cost or market, (b) cost, or (c) fair market value. When dealers used derivatives to hedge inventories, the derivatives were accounted for under their own system, and so dealers were able to manage their tax positions arbitraging the difference between the inventory and

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[39] Notional Principal Contracts; Contingent Nonperiodic Payments: Notice of Proposed Rulemaking, *Fed. Reg.* vol. 69, 38, February 26, 2004, p. 8886.

[40] *Ibid.*

[41] Prop. Treas. Reg. sec. 1.1234A-1.

[42] Prop. Treas. Reg. sec. 1.1234A-1(b).

derivatives rules. In addition, by using lower of cost or market, dealers could get the benefit of unrealized losses and avoid recognizing unrealized gains.

In 1993, Congress provided a uniform rule[43] for the taxation of securities held by securities dealers of all types:

- A security that is inventory is included in inventory at the close of the taxable year at its fair market value; and
- All other securities held at the close of the taxable year are treated as sold on the last business day of the taxable year at their fair market value.

The character of gain or loss from the mark to market or the disposition of a security under section 475 is ordinary.[44]

"Security" is defined broadly, to include stocks, interests in widely held or publicly traded partnerships and trusts, debt instruments, interest rate swaps, currency swaps, and equity swaps, as well as options, forwards, and short positions on any of the above-mentioned financial instruments, and other positions identified as hedges with respect to any of the above-mentioned instruments. Section 1256 contracts are excluded.[45]

A dealer in securities is also broadly defined, as: (a) a taxpayer that regularly purchases securities from, or sells securities to, customers in the ordinary course of business, or (b) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of business.[46]

There are three exceptions to the mark to market rules:

- Securities held for investment that are properly identified as such.[47]
- Debt originated or entered into in the ordinary course of a securities dealer's business that is not held for sale and that is properly identified as such.[48]
- Hedges entered into by a dealer of positions that are not securities or of securities that are not required to be marked to market.[49]

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[43] Sec. 475(a).

[44] Sec. 475(c)(3).

[45] Sec. 475(c)(2).

[46] Sec. 475(c)(1).

[47] Sec. 475(b)(1).

[48] Sec. 475(b)(2).

[49] Sec. 475(b)(1)(C).

Section 475 was expanded to allow traders in securities and dealers and traders in commodities to elect to be treated in the same manner as dealers in securities.[50]

Virtually all derivatives trades in the United States have, on at least one side, either an exchange or a taxpayer subject to section 475. For more than twenty years, at least one party to almost all derivative trades in the United States has been subject to mark to market taxation. The major issues for taxpayers and the IRS implementing mark to market relate to: (1) taxpayers crossing from non-section 475 to section 475 status; (2) securities crossing either direction from non-mark to market to mark to market status; or (3) managing the discrepancies between book and tax.

Combinations of transactions

The tax law generally provides rules for financial positions – such as a derivative and an underlying – in isolation from one another, without taking into account what else a taxpayer may have in its portfolio. However, the financial consequence of entering into a combination of positions may be different from entering into one or other of them in isolation. As the disparity between the financial outcome of combining positions, and the tax outcome of treating them separately became known, legislation and administrative guidance have on occasion provided for the taxation of transactions in financial positions while considering what else a taxpayer has in its portfolio. These rules for combinations of positions have been added to the Code and regulations *ad hoc*.

Examples of the rules for combinations of financial positions (several of which are discussed in more detail below) include:

- Straddle rules in section 1092
- Business hedging rules in section 1221
- Short sale rules in section 1233
- Conversion rules in section 1258
- Constructive sale rules in section 1259
- Constructive ownership rules in section 1260
- Debt hedging rules in Treas. Reg. sec. 1.1275-6
- Foreign currency hedging in section 988

[50] Secs. 475(e) and (f).

Straddles[51]

"Straddle shelters" were transactions involving futures contracts entered into to accelerate recognition of loss, defer recognition of gain and convert income that would have been taxed at ordinary rates into income taxed at long term capital gains rates, in an era of large differences between the highest ordinary income and long term capital gains rates.[52]

The advantages of entering into straddle shelters ended with the enactment of a set of related laws ("straddle provisions"). With their broad, sometimes uncertain meaning, the straddle provisions potentially apply to the hedging of all capital assets, whether or not such transactions have the potential for abuse. The straddle rules attempt to govern contracts with great flexibility in a system: (1) designed for property with less flexible features, (2) that relies on realization as the primary signal to tax property transactions, and (3) in which the distinction between ordinary income and capital gains is based on the legal form of transactions rather than their economic substance.

Loss deferral

Loss on one leg of a straddle is not allowed for tax purposes to the extent a taxpayer has unrecognized gain in an "offsetting" position. This rule is in section 1092.

Section 1092 defines a straddle as offsetting positions with respect to personal property of a type that is actively traded.[53] Positions are offsetting if there is a "substantial diminution of risk of loss" from holding any position in actively traded property by holding one or more other positions with respect to actively traded property.[54] The term "substantial diminution of risk of loss" is central to application of the straddle rules, but it is not defined in the Code and its meaning has been uncertain since enactment.

Actively traded personal property is any personal property for which there is an established financial market.[55] Regulations defining "established financial market" take an expansive view of the term. A position is an interest in personal property, including a futures contract, a forward, or an option.[56] A notional principal contract constitutes property of a type

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[51] *See*, Festschrift honoring the first quarter century of the straddle rules, "Examining the Straddle Rules after 25 Years," *Tax Notes*, December. 21, 2009.

[52] For a description of typical straddle shelters and review of straddle history, *see* Viva Hammer, "U.S. Taxation of Foreign Currency Derivatives: 30 Years of Uncertainty," *Bulletin of International Taxation*, vol. 64, no. 3, March 2010, expanded and updated in Practising Law Institute, *Taxation of Financial Products and Transactions*, Matthew A. Stevens (ed.), 2013.

[53] Sec. 1092(c)(1) and (d)(1).

[54] Sec. 1092(c)(2)(A).

[55] Treas. Reg. sec. 1.1092(d)-1(a).

[56] Sec. 1092(d)(2).

that is actively traded if contracts based on the same or substantially similar indicies are purchased, sold, or entered into on an established financial market. The rights and obligations of a party to a notional principal contract are rights and obligations with respect to personal property and constitute an interest in personal property.[57] A position does not have to be actively traded in order to come within the straddle rules; only the property that underlies the position need be actively traded.

Section 1092(a) provides that a taxpayer's loss with respect to one position that is part of a straddle may only be taken into account to the extent that the loss exceeds the taxpayer's unrecognized gain with respect to any offsetting position that is part of the straddle.[58] The taxpayer may carry forward any disallowed loss into succeeding taxable years.[59]

Exceptions from the straddle rules are provided for hedging transactions,[60] straddles composed entirely of section 1256 contracts,[61] and qualified covered calls.[62] Special rules apply to mixed straddles (generally, straddles comprised of both section 1256 contracts and non-section 1256 contracts)[63] and for identified straddles.[64]

Holding periods

A taxpayer's holding period on a position does not run while the position is part of a straddle. If the position had already attained long term holding statuson a position before it

[57] Treas. Reg. sec. 1.1092(d)-1(c).

[58] Sec. 1092(a)(1)(A).

[59] Sec. 1092(a)(1)(B).

[60] Sec. 1092(e). A hedging transaction is a transaction entered into in the normal course of the taxpayer's trade or business primarily to manage the risk of price changes or currency fluctuations with respect to ordinary property held by the taxpayer or to manage the risk of interest rate changes, price changes, or currency fluctuations with respect to borrowings made or ordinary obligations incurred by the taxpayer. Sec. 1221(b)(2)(A). To qualify as a hedging transaction for purposes of the straddle rule exception, the transaction must be clearly identified as such before the close of the day on which the transaction was entered into. Sec. 1256(e)(2).

[61] Sec. 1256(a)(4).

[62] Sec. 1092(c)(4); Treas. Reg. sec. 1.1092(c)-1(b).

[63] Sec. 1092(b)(2). If a straddle consists of positions that are section 1256 contracts and non-section 1256 contracts, the taxpayer may designate the positions as a mixed straddle. Positions in a mixed straddle are not subject to the mark to market rule of section 1256, but instead are subject to regulations designed to prevent the deferral of tax or the conversion of short term capital gain into long term capital gain or the conversion of long term capital loss into short term capital loss.

[64] Sec. 1092(a)(2). If a taxpayer clearly identifies a straddle as such before the close of the day on which the straddle is acquired, then the loss deferral rules of section 1092(a) do not apply. Instead, any loss incurred with respect to a position that is part of an identified straddle is added to the tax basis of the offsetting positions in the straddle. Sec. 1092(a)(2)(A); William R. Pomierski, "Identified Straddles: Uncertainties Resolved and Created by 2007 Technical Corrections," *Journal of Taxation of Financial Products*, vol. 7, no. 2, 2008, pp. 5-10, 55-57.

became part of the straddle, then the position retains its long term holding status while the position is part of the straddle.[65]

Carrying costs

Interest on debt and other carrying costs paid or incurred to purchase or carry property that is part of a straddle that is greater than interest and related income of a taxpayer, is not deductible and goes to the capital account of the property.[66]

Mark to market

Certain derivatives are required to be marked to market, and any resulting gain or loss is treated as 60 percent long term and 40 percent short term capital gain or loss.[67] The concept of taxing derivatives on a mark to market basis was raised during Congressional debates in 1981. A mark to market approach was offered as an alternative to the principal solution to the straddle abuses, the "balanced position" (loss deferral) rule. John Chapoton, Assistant Secretary for Tax Policy at the U.S. Treasury Department, said that the balanced position rule could not apply to taxpayers with a significant volume of transactions because it required "the identification of particular positions, [and would be] cumbersome to apply. There is also the risk that such a rule could be avoided by these market participants."[68] Instead, Treasury proposed that a "special rule" would apply to these taxpayers.

> "In lieu of the balanced position rule, we propose that these persons be subject to a mandatory mark to market rule for their positions in futures contracts traded on an organized futures exchange. Because futures positions are marked to market on a daily basis under the normal operating rules of the exchange, with actual cash settlements on a daily basis, this rule does no more than make the tax laws reflective of the underlying market transactions."[69]

Section 1256 provides special timing and character rules for certain types of derivatives, mostly those traded on a US exchange. Any section 1256 contract held by a taxpayer at the close of a taxable year is marked to market, that is, the contract is treated as having been sold by the taxpayer for its fair market value on the last business day of the taxable year.[70] The character of

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[65] Treas. Reg. sec. 1.1092(b)-2T(a)(1).

[66] Sec. 263(g).

[67] Sec. 1256.

[68] Commodity "Tax Straddles": Hearing before the House Committee on Ways and Means, 97th Cong. 71 (1981) (statement of John E. Chapoton, Assistant Secretary for Tax Policy).

[69] *Ibid.* at p. 63.

[70] Sec. 1256(a)(1).

gain or loss on the mark to market, or if the contract is terminated or transferred,[71] is 60 percent long term capital gain or loss, and 40 percent short term capital gain or loss, regardless of the taxpayer's holding period.[72] Foreign currency contracts that are governed by both sections 1256 and 988 have more complex character rules.[73]

A section 1256 contract is defined as:[74] (1) a regulated futures contract, (2) a foreign currency contract, (3) a nonequity option traded on or subject to the rules of a qualified board or exchange, (4) an equity option purchased or granted by an options dealer that is listed on a qualified board or exchange on which the dealer is registered, and (5) a securities futures contract entered into by a dealer that is traded on a qualified board or exchange. Excluded from the definition of section 1256 contracts are (1) any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract, and (2) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.[75]

In 1982, section 1256 was expanded to include "foreign currency contracts." The scope of that term has been the subject of controversy since enactment, with the result that foreign currency forwards on major currencies are subject to mark to market, but the treatment of foreign currency options is uncertain.[76] Section 1256 foreign currency derivatives are an example of the inconsistency between the economic substance of a transaction and tax consequences that follow form.[77]

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[71] Sec. 1256(c)(1).

[72] Sec. 1256(a)(3). This general rule does not apply to 1256 contracts that are part of certain hedging transactions or section 1256 contracts that, but for the rule in section 1256(a)(3), would be ordinary income property.

[73] The interaction between section 988 governing foreign currency transactions and section 1256 is complex, *see* Viva Hammer, "U.S. Taxation of Foreign Currency Derivatives: 30 Years of Uncertainty," *fn.* 52, above.

[74] For definitions of these terms, see section 1256(g).

[75] Sec. 1256(b)(2).

[76] The treatment of foreign currency options that form part of a tax shelter has been the subject of litigation. See, *Wright v. Commissioner*, 117 AFTR 2d ¶ 2016-319, reversing a Tax Court holding (TC Memo 2011-292), and contrary to a prior Tax Court case *Summitt v. Commissioner*, 134 T.C. 248, 249-54 (2010).

[77] For a report on practitioner debate on this matter, *see* "Taxpayers Win in Indecision Over Foreign Currency Options" Daily Tax Report, 47 DTR G-3 (March 10, 2016); "Court Decision Spurs Foreign Currency Option Treatment Debate," *Tax Notes* (March 14, 2016).

Business hedging

Background and legislative history

Nonfinancial businesses may use derivatives to manage (among other things) changes in prices of inputs, of interest rates on borrowings, foreign currency fluctuations, revenue streams, and items that could affect profits (for example, weather).

Whether derivatives that are used to hedge business risks were capital or ordinary items, and how they should be accounted for, was a matter of case law[78] and administrative guidance until Treasury regulations were published in 1993 and 1994 governing the timing and character of hedging transactions under sections 1221 and 446 respectively. In 1999, Congress amended section 1221 to include business hedging transactions as exceptions to the definition of capital asset, and in 2002 final Treasury regulations were published under the new legislation. Regulations under section 446 governing timing of hedging transactions were not changed.

Definition of hedging transaction

Section 1221(b)(2) defines a hedging transaction as any transaction entered into in the normal course of the taxpayer's trade or business primarily to manage risk of price changes or currency fluctuations with respect to ordinary property held or to be held by the taxpayer, or to manage risk of price changes or currency fluctuations with respect to borrowings made or to be made or ordinary obligations incurred or to be incurred by the taxpayer, or other risks as the Secretary prescribes in regulations.

The regulations under section 1221 do not define the term "primarily to manage risk," stating that it is a facts and circumstances determination.[79] The regulations provide several examples of risk management activity. Only those hedges that fall within the Code definition are given ordinary treatment. Hedges of revenue, dividend or royalty streams, profit margin hedging and hedging of capital assets are not covered by the definition of business hedge. Neither are hedges that hedge the gap between a taxpayer's liabilities and the assets purchased to meet the taxpayer's obligations (unless such hedges can be shown to be hedges of the liabilities).

Taxpayers are required to identify hedging transactions and the items being hedged in a timely manner. Hedges must be identified by the close of the day on which a taxpayer enters into the hedging transaction.[80] The identification must be made on, and retained as part of, the taxpayer's books and records.[81] The identification of a hedging transaction for financial

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[78] Corn Prods. Ref. Co. v. Comm'r. 350 US 46 (1955), Arkansas Best Corp. v. Commissioner 485 US 212 (1988), Federal Nat'l Mortgage Ass'n v. Commissioner 100 TC 541 (1993).

[79] Treas. Reg. sec. 1.1221-2(c)(4)(i).

[80] Treas. Reg. sec. 1.1221-2(f)(1).

[81] Treas. Reg. sec. 1.1221-2(f)(4)(i).

accounting or regulatory purposes does not satisfy this requirement unless the taxpayer's books and records indicate that the nontax identification is also being made for tax purposes.[82]

Timing of hedging gains and losses

Regulations under section 446 provide that taxpayers must account for gains and losses from hedging transactions in a manner that clearly reflects income, which the regulations define as reasonably matching the timing of income, deduction, gain or loss from the hedging transaction with the income, etc., of the risk being hedged.[83] That is, the timing on the hedge follows the timing on the hedged item. When a taxpayer enters into a hedge on an item and disposes of the item but does not dispose of the hedge, the built in gain or loss on the hedge must be matched to the gain or loss on the item that has been disposed of, which requirement can be met by marking the hedge to market on the day of the disposition.[84]

Constructive sales

Legislative history

During the 1990s, when the stock market was appreciating and volatile, some taxpayers wished to hold on to their appreciated stock, while hedging the risk of loss without paying tax on the appreciation. Several derivative transactions allowed them to accomplish these goals, including using short sales, forward and swap contracts, as well as combinations of options.

Section 1259, enacted in 1997, provides that a taxpayer must recognize gain on certain appreciated assets on entering into a short sale, an offsetting notional principal contract, a forward or futures contract on the same or substantially identical property as the appreciated asset.[85] Regulatory authority permits the Treasury Secretary to add to the list of transactions that trigger gain recognition to the extent those transactions have substantially the same effect as the transactions specifically listed. The Secretary has not exercised this authority.

Property subject to section 1259

The property subject to section 1259 is any "appreciated financial position" with respect to any stock, debt instrument,[86] or partnership interest. The relationship between the appreciated financial position and the transactions that trigger gain under section 1259 is elucidated in two

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[82] Treas. Reg. sec. 1.1221-2(f)(4)(ii).

[83] Treas. Reg. sec. 1.446-4(b).

[84] Treas. Reg. sec. 1.446-4(e)(6).

[85] Sec. 1259(c)(1).

[86] There is an exception for debt if it is payable at a fixed rate or a qualifying variable rate and the debt is not convertible into stock of the issuer or a related person, or is marked to market under some other rule. Sec. 1259(b)(2).

ways. In the language of the statute, an "offsetting notional principal contract," is an agreement which includes a requirement to pay (or provide credit for) all or substantially all of the investment yield (including appreciation) on such property for a specified period, and a right to be reimbursed for (or receive credit for) all or substantially all of any decline in the value of such property.[87]

Legislative history provides:[88]

> "It is anticipated that the Treasury will use the provision's authority to treat as constructive sales other financial transactions that...have the effect of eliminating substantially all of the taxpayer's risk of loss and opportunity for income or gain with respect to the appreciated financial position."

Section 1259 omits an option, or combination of options, as one of the transactions that could trigger the realization of gain, possibly because a single option would not "have the effect of eliminating" loss and gain potential when holding an appreciated position. Combinations of options, such as a put and call on the same underlying with the same or close strike prices, could potentially "have the effect of eliminating" loss and gain potential when holding an appreciated position.

Both sections 1092 and 1259 address capital hedging transactions, that is, when a taxpayer has a capital asset and a derivative that hedges some part of the financial risk of owning the asset. The two sections provide different tests to trigger their application. Section 1092 provides for loss deferral (and other consequences) when one position results in a substantial diminution of risk of loss in another position. Section 1259 provides for gain recognition when one position has the effect of eliminating loss and gain potential in one position by entering into another position. In contrast, section 1221 provides for special character and timing rules for the hedge (which would otherwise be a capital asset) when it is entered into for the purpose of managing risk on ordinary business assets and activities. These tax rules applicable to combinations of positions differ from the tax rules applicable to assets or derivatives when held on their own.

Insurance companies holding debt

Under present law, insurance companies are subject to Federal income tax computed under section 11 (the tax imposed on corporations in general), on either life insurance company taxable income in the case of a life insurance company, or on taxable income in the case of an insurance company other than a life insurance company (such as a property and casualty insurance company).[89]

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[87] Sec. 1259(d)(2).

[88] Senate Finance Committee Report on the Revenue Reconciliation Bill of 1997 (S. 949), S. Rep. No. 105-33, 105th Cong., 1st Sess. 127 (Comm. Print 1997) at p. 126.

[89] Secs. 801(a) and 831(a).

Present law defines a capital asset as property held by the taxpayer whether or not connected with the taxpayer's trade or business, subject to certain exceptions.[90] Insurance companies are not treated as financial institutions for purposes of the present-law rule that the sale or exchange by a financial institution of a bond, debenture, note or certificate or other evidence of indebtedness is not considered the sale or exchange of a capital asset.[91] Thus, such an asset generally is treated as a capital asset in the hands of an insurance company, even if the asset is connected with the company's trade or business of insurance.

Description of Discussion Draft

In general

MODA unifies and simplifies the treatment of derivatives, with one timing rule, one character rule and one sourcing rule for all derivative contracts. MODA expands the scope of the mark-to-market timing rule to a broader class of taxpayers and contracts than has been subject to that rule in the past. Gain or loss from derivative contracts and certain related assets are treated as ordinary income or loss under MODA. The source of flows on derivatives under MODA is generally the country of residence of the taxpayer.

Definition of derivative

In general

A derivative is any contract[92] the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more of the following: (1) any share of stock in a corporation, (2) any partnership or beneficial ownership interest in a partnership or trust, (3) any evidence of indebtedness, (4) any real property (other than real property for which an exclusion is available (discussed further below)), (5) any commodity that is actively traded within the meaning of section 1092(d)(1), (6) any currency, (7) any rate, price, amount, index, formula, or algorithm, and (8) any other item prescribed by the Secretary. The term derivative does not include any item described in (1) through (8).[93]

The term derivative includes an embedded derivative component. If a contract has derivative and non-derivative components, then each derivative component is treated as a derivative. If an embedded derivative component cannot be separately valued, the entire contract that includes the embedded derivative component is treated as a derivative. A debt instrument is not treated as having an embedded derivative component merely because it is denominated in a foreign currency or payments with respect to such debt instrument are determined by reference to the value of a nonfunctional currency.

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[90] Sec. 1221.

[91] Sec. 581(c).

[92] Including any option, forward contract, futures contract, short position, swap, or similar contract.

[93] Section 493, as added by section 2 of the discussion draft.

Exclusions

American depository receipts

American depository receipts ("ADRs") and similar instruments with respect to shares of stock in foreign corporations are treated as shares of stock in such foreign corporations and not as derivatives, except as otherwise provided by the Secretary.

Real property

A derivative does not include a contract with respect to interests in real property (as defined in section 856(c)(5)(C)) if the contract requires physical delivery of the real property. This exclusion from the definition of a derivative is provided so that common residential and commercial real estate transactions that are pending at the end of a taxable year are not subject to the general rule for derivatives. For example, a taxpayer that enters into an option to buy or sell a residence or an office building does not have a taxable event at the close of the taxable year under this exception, provided that, if the taxpayer exercises the option, physical delivery of the residence or building (as opposed to cash settlement[94]) is required by the contract.

This exception includes contracts that facilitate the sale or purchase of physically delivered real property. For example, the discussion draft would treat a residential mortgage interest rate lock entered into by natural persons as a contract with respect to interests in real property requiring physical delivery because the interest rate lock contract is related to the purchase of real property that will be physically delivered even though physical property is not delivered under the interest rate contract itself.

Financing transactions

To the extent provided by the Secretary, a derivative does not include the right to the return of the same or substantially identical securities transferred in a securities lending transaction, a sale-repurchase transaction or similar financing transaction. A securities lending transaction is a transfer of one or more securities that is described in section 1058(a) as amended or a substantially similar transaction. A sale-repurchase transaction is an agreement under which a person transfers a security in exchange for cash and simultaneously agrees to receive substantially identical securities from the transferee in the future in exchange for cash. A security for these purposes is a share of stock in a corporation, a partnership, or beneficial ownership interest in a partnership or trust, or any evidence of indebtedness.

Hedging transactions

Any contract that is part of a hedging transaction within the meaning of section 1221(b), as amended, or section 988(d)(1), as amended, is excluded from the definition of derivative.

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[94] For this purpose, a contract which provides for the option of cash settlement is not treated as requiring physical delivery of real property unless the option is not exercisable unconditionally, and exercisable only in unusual and exceptional circumstances.

Other exclusions

The discussion draft excludes from the definition of a derivative an option described in section 83(e)(3) received in connection with the performance of services. It also excludes an insurance, annuity, or endowment contract issued by an insurance company to which subchapter L applies (or, in the case of a foreign corporation, would apply if the foreign corporation were domestic). A contract that is otherwise within the definition of a derivative is not treated as a derivative if it is with respect to stock issued by any member of the same worldwide affiliated group (within the meaning of section 864(f)(1)(C)) in which the taxpayer is a member. A contract with respect to a commodity that is otherwise within the definition of derivative is not treated as a derivative if the contract requires physical delivery, with the option of cash settlement only in unusual and exceptional circumstances, and the commodity is used in the normal course of the taxpayer's trade or business,[95] and the derivative relates to quantities normally used in the normal course of that trade or business.

Timing rules for derivatives[96]

MODA requires gain or loss to be recognized and taken into account, if there is a taxable event with respect to a derivative, in the year the taxable event occurs. Any gain or loss taken into account as a result of subsequent taxable events with respect to the derivative is determined only after proper adjustment has been made for gain or loss recognized as a result of any prior taxable event. In this way, taxable events with respect to a derivative are linked by adjustments made in successive periods through the life of the derivative. Regardless of a taxpayer's overall method of accounting, any payment with respect to a derivative (that does not constitute a taxable event) is taken into account at the time the payment occurs and proper adjustment must be made to the amount of any subsequent gain or loss with respect to the derivative as a result of such payment.

MODA provides for two types of taxable events for derivatives that are not part of an investment hedging unit (discussed below): (1) the close of the taxable year if a taxpayer has rights or obligations with respect to a derivative at such time, and (2) the termination or transfer of a derivative during the taxable year. For this purpose, "termination or transfer" includes with respect to any derivative, but is not limited to, any termination or transfer by offsetting, by taking or making delivery, by exercise or being exercised, by assignment or being assigned, by lapse, by sale or other disposition, by assumption, or otherwise.

The amount of gain or loss taken into account on the occurrence of a taxable event is: (1) in the case of a termination or transfer of a derivative, the amount of gain or loss that would otherwise be determined under the Code, and (2) in all other cases, the amount that would have been taken into account had the taxable event been a termination or transfer.

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[95] In the case of an individual, if the commodity is used for personal consumption.

[96] Section 491, as added by section 2 of the discussion draft.

When the taxable event is the close of the taxable year in which the taxpayer has rights or obligations with respect to a derivative, the taxpayer is required to determine the fair market value of the derivative as if it had been terminated or transferred at that time. It is intended that taxpayers use sources of information and valuation methods consistently from period to period to determine the fair market value, incorporating developments in the financial markets and advances in financial engineering in a reasonable and fair manner. For these purposes, the taxpayer may rely on valuations provided by a broker under section 6045(b).

In addition, a taxpayer may rely on nontax reports and statements for valuation of a derivative. MODA requires taxpayers to prioritize the use of certain reports and statements if they are available (*i.e.*, "applicable financial statements"). First, a taxpayer must use financial statements certified as being prepared in accordance with U.S. generally accepted accounting principles ("GAAP"). Of those statements, taxpayers must prioritize in the following manner: (1) a 10-K or successor form or annual statement to shareholders required to be filed by the taxpayer with the U.S. Securities and Exchange Commission ("SEC"); or, (2) if no statement described in (1) is available, an audited financial statement given to creditors to make lending decisions, reporting to shareholders, partners, other proprietors or beneficiaries, or for other substantial nontax purposes; or, (3) if no statements described in (1) or (2) are available, a statement filed by the taxpayer with any other Federal agency for purposes other than Federal tax purposes.

Second, if no audited GAAP financial statements are available, taxpayers may use financial statements prepared in accordance with international financial reporting standards ("IFRS") required to be filed with agencies of a foreign government equivalent to the SEC in jurisdictions that have reporting standards at least as stringent as those in the United States.

Last, if neither audited GAAP financial statements nor financial statements prepared in accordance with IFRS are available, taxpayers may use statements provided to other regulatory or governmental bodies as provided by the Secretary.

Investment hedging units ("IHUs")[97]

MODA provides a comprehensive regime for a taxpayer that simultaneously has obligations or rights with respect to a derivative and owns the underlying investment referenced by the derivative, to the extent that those combinations of derivatives and underlying investments are not governed by some other rule (*e.g.*, business hedges under section 1221, as amended). MODA provides: (1) for the harmonization of the disparate rules during the period a taxpayer has both obligations or rights with respect to a derivative and owns the underlying investment referenced by the derivative, (2) rules for the time a taxpayer either owns an underlying investment and enters into a derivative contract or has obligations or rights with respect to a derivative and acquires the underlying investment, and (3) rules for when either the taxpayer terminates or transfers its obligations or rights with respect to a derivative, or disposes of the underlying investment.

[97] Section 492, as added by section 2 of the discussion draft.

In general, a taxpayer is considered to have an IHU during an applicable hedging period when it holds the following positions: (1) derivatives that have the same or substantially identical underlying investment, and (2) underlying investments, portions of underlying investments, or items substantially identical to those underlying investments, that have a certain financial ("delta") relationship with the derivatives described in (1). A taxpayer is required to identify the positions in an IHU, and it is also required to identify those derivatives and underlying investments which could be part of the IHU but do not meet the financial ("delta") relationship. The "delta" relationship means, with respect to any derivative and underlying investment, the ratio of the expected change in the fair market value of the derivative to any change in the fair market value of the underlying investment. Thus, an IHU consists of: (1) all derivatives with respect to an underlying investment that, in combination, have a delta with respect to any portion of the underlying investment that is between the range beginning with minus 0.7 and ending with minus 1.0, and (2) portions (which may include all) of the the underling investment (the "delta test"). The delta test is to be conducted in a commercially reasonable manner consistent with the methods used in the preparation of a taxpayer's financial statements (except if the Secretary provides otherwise).

Establishment of an IHU

IHUs are formed in three ways, and may be governed by two different accounting methods. IHUs can be formed by one or more derivatives and underlying investments or parts thereof, (1) meeting the delta test and being identified by the taxpayer, (2) without regard to conducting the delta test by a taxpayer electing to be subject to the IHU rules, or (3) meeting the delta test without taxpayer identification.

Identified IHUs

Derivatives and their underlying investments are required to be tested for the delta relationship, and identifications must be made: (1) at the beginning of the period in which the taxpayer holds one or more derivatives with respect to an underlying investment; and (2) during the period in which the taxpayer has both rights or obligations with respect to one or more derivatives and portions of the underlying investment: (a) immediately after the taxpayer enters into another derivative with respect to the underlying investment; (b) immediately after the taxpayer acquires an additional amount of underlying investment; (c) immediately after the taxpayer terminates or transfers its rights or obligations with respect to one or more derivatives with respect to the underlying investment, and (d) immediately after the taxpayer sells or exchanges any portion of the underlying investment; and (3) at such other times during such period as the Secretary may prescribe. No other testing or identification is required or permitted, except as provided by the Secretary.

Electing IHUs

A taxpayer can elect to establish an IHU if it owns any underlying investment and any derivatives with respect to that underlying investment (without any need to conduct the delta test) (an "IHU election"). The IHU election applies to all portions of the underlying investment owned by the taxpayer and all rights and obligations with respect to derivatives on the underlying investment held by the taxpayer after the election is made, whether or not the

derivatives and underlying investments are held simultaneously for some portion of that period. The election is irrevocable.

Taxpayers failing to identify an IHU or make an election with respect to an IHU

If a taxpayer has rights or obligations with respect to derivatives and underlying investments with respect to the derivatives and those positions together form an IHU and the taxpayer: (1) fails to make the identification required for an IHU, and (2) fails to make an IHU election, then the taxpayer will be treated as having made an IHU election as of the first time the taxpayer has positions which together form an IHU. The election may be revoked only with the consent of the Secretary.

Identifications and elections described above are expected to form part of the taxpayer's books and records.

Timing rules for positions in an IHU

The following are taxable events with respect to positions in an IHU: (1) the establishment of an IHU, (2) the termination or transfer of any derivative that is part of an IHU, (3) the sale or exchange of all or any portion of any underlying investment that is part of an IHU, (4) the entering into after the establishment of the IHU of another derivative or the acquisition of an additional amount of underlying investment if either of these form part of the IHU, (5) in the case the taxpayer has made an election, or is treated as having made an election, under proposed section 492(b) (relating to items included in the IHU), the close of each business day, and (6) in the case of any other IHU, the close of any taxable year in which the taxpayer has an IHU.

The amount of gain or loss on the occurrence of a taxable event for an IHU is: (1) in the case of a termination or transfer of a derivative, the amount of gain or loss that would otherwise be determined under the Code, (2) in the case where there is a taxable event with respect to a derivative that is not a termination or transfer, the amount that would have been taken into account had the taxable event been a termination or transfer, (3) in the case where an underlying investment is sold or exchanged, the amount of gain or loss that would otherwise be determined under the Code, and (4) in the case where there is a taxable event with respect to an underlying investment that is not a sale or exchange, the amount that would have been taken into account had the taxable event been a sale or exchange.

When a taxpayer establishes an IHU, or when positions are added to an IHU, no built in loss is recognized with respect to any position in the IHU. Built in gain with respect to any position is, however, recognized and realized when a taxpayer establishes an IHU, or adds positions to an IHU, and the gain has the character it would have had if the item had been sold or exchanged, terminated or transferred under general principles.

Character of gains and losses, etc., on derivatives and underlying investments

Any item of income, deduction, gain, or loss taken into account with respect to a derivative is treated as ordinary income or loss and is treated as attributable to the trade or business of the taxpayer for purposes of section 172(d)(4) (relating to net operating loss deductions).

Similarly, any item of income, deduction, gain, or loss taken into account with respect to an underlying investment that is part of an IHU is treated as ordinary income or loss and is treated as attributable to the trade or business of the taxpayer for purposes of section 172(d)(4) (this does not include the recognition of built in gain on establishing or adding positions to an IHU).

Source of gain or loss from derivatives

Any item of income, deduction, gain or loss taken into account with respect to a derivative is treated as derived from sources within the country of residence of the taxpayer, except to the extent that section 871(m) applies to payments with respect to a derivative. This residence-based source rule is not intended to affect the determination of whether income is effectively connected with the conduct of a U.S. trade or business

Bonds of certain insurance companies treated as ordinary

MODA adds a new exception to the definition of a capital asset in the case of an applicable insurance company.[98] Specifically, a capital asset does not include any bond, debenture, note, or certificate or other evidence of indebtedness held by an applicable insurance company. To prevent selective changes to the character of an asset, or character changes from year to year (for example, if a company is not an applicable insurance company every year), a rule is provided that if an asset is so treated with respect to an applicable insurance company for any taxable year, the asset is so treated during any subsequent taxable year the asset is held by the company. Regulatory authority is provided as may be necessary or appropriate to carry out the purposes of the provision, including to prevent the avoidance of Federal income tax through sale or exchange of assets described in the new capital asset exception.

An applicable insurance company means an insurance company that meets statutory requirements. First, it must be a company, more than half the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.[99] Further, it must be subject to tax under section 801(a) or 831(a). In addition, to meet the definition of an applicable insurance company, certain special tax rules applicable to some insurance companies are not applicable to the company, specifically, section 831(b) (relating to an election to be taxed only on taxable investment income), 835 (relating to an election by a reciprocal underwriter), 842 (relating to foreign companies carrying on insurance business), 847 (relating to special estimated tax payments), or 833(a)(1) (that is, the company is not treated as a stock insurance company solely by reason of section 833(a)(1)).

[98] Sec. 1221(a)(9) as added by the discussion draft.

[99] Sec. 816(a).

Effective Date

The discussion draft is generally effective for taxable events occurring after the 90-day period beginning with the date of enactment, in taxable years ending after the last day of such period. A transition rule applies to derivatives and underlying investments held as of the close of such 90-day period.

With respect to debt instruments held by insurance companies, the discussion draft is effective for any bond, debenture, note, or certificate or other evidence of indebtedness held or acquired after the 90-day period beginning with the date of enactment.

A transition rule applies with respect to capital loss carryforwards to taxable years beginning after the close of the 90-day period beginning with the date of enactment. The purpose of the transition rule is to limit the amount of pre-effective date capital losses allowed in any taxable year beginning after that date to the amount of capital loss that would have been allowed if pre-effective date law applied. Specifically, under the transition rule, in addition to any other short term capital gain of the taxpayer, the taxpayer treats as short-term capital gain (rather than ordinary income) an amount equal to the lesser of: (1) the net gain (if any) from sales or exchanges during the taxable year of assets to which new section 1221(a)(9) applies, or (2) the capital loss carryovers to that taxable year from any taxable year beginning before the close of the 90-day period beginning with the date of enactment.