MODERNIZATION OF DERIVATIVES TAX ACT DISCUSSION DRAFT

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Taxation of derivatives is an example of how complexity in the tax code is the enemy of fairness. Under current law, tax pros are able to exploit the complex rules for derivatives to delay paying taxes or minimize what they do pay, in ways that typical working Americans who receive a paycheck cannot do. The Modernization of Derivatives Tax Act (MODA) discussion draft would prevent sophisticated taxpayers from using derivative contracts to avoid paying taxes on their underlying investments. This proposal represents an important step in leveling the playing field between the taxation of income from work and income from wealth. The draft would radically simplify one of the most complex and uncertain areas of our tax code. The Joint Committee on Taxation scored this legislation as raising $16.5 billion over ten years.

Derivative contracts are financial bets between two parties on whether a stock, commodity, or other underlying investment will go up or down in value over some period of time. Trillions of dollars in derivatives – including options, swaps, forwards, and futures – are traded or exercised each year in the U.S. Yet, there are no general principles governing the taxation of derivatives. Instead, complex, inconsistent, and often spotty tax rules allow sophisticated taxpayers to exploit mismatches in the tax treatment of different investments to minimize their tax bill – to effectively pay what they want in taxes, when they want. For example, taxpayers can use derivatives like forward contracts to lock in a lower tax rate if they expect gains, or a higher tax deduction if they expect losses. Or, they can use derivatives like option “collars” to secure investments and remove risk of loss even while benefitting from low tax rates intended only for taxpayers who bear actual risk. By contrast, middle class working families are stuck paying ordinary tax rates on every pay check – if they own stocks or other investments, they must ride the ups and downs of the market. This legislation would scrap most current rules and regulations for taxing derivatives in favor of a new, modernized system which would do the following:

Require mark to market and ordinary tax treatment for all derivatives. The taxation of derivatives may vary widely depending on how the underlying investment is taxed, the type of derivative contract and how long it was held, the source country of the transaction, and even the nature of the taxpayer. Sophisticated taxpayers can use derivatives to selectively realize losses just to wipe out taxes on other gains. So the draft would require mark to market treatment for derivatives, treating these contracts as if they had been sold and repurchased at the end of each year. The draft would then require ordinary tax treatment on the resulting gains and losses.

Radically simplify the tax rules for financial products. The draft would replace the current crazy quilt of inconsistent derivative tax rules and instead apply a single tax regime to all derivative contracts that includes one rule for transaction timing (mark to market), one rule for character (ordinary), and one rule for source (taxpayer’s country of residence). The draft would repeal nine tax code sections and streamline many others, including associated regulations. The draft would also unify valuation rules for tax and book purposes.

Identify and tax substantial hedges on capital assets. Sophisticated taxpayers may use derivatives to fully secure or “hedge” the value of their investments. For example, an investor could all but eliminate the risk of a stock losing its value by acquiring the option to sell the stock if it fell below a certain price. The draft would install a capital hedging rule requiring mark to market and ordinary income tax treatment for combinations of derivatives and their underlying investments, which are identified to have a substantial hedging relationship.

Target tax avoiders, and spare taxpayers hedging risks and trying to comply with a complex code. MODA is aimed at the sliver of sophisticated taxpayers who use derivatives to avoid paying taxes on their investments. MODA is not directed at the banks, businesses, and individuals that hedge business risks, or employees who receive stock options, or derivative transaction in pension funds, endowments, insurance contracts, or annuities, or in certain transactions aimed at keeping mortgage rates low.