MODERNIZATION OF DERIVATIVES TAX ACT OF 2017

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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. The Modernization of Derivatives Tax Act (MODA) will 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. This bill will radically simplify one of the most complex and uncertain areas of our tax code. The Joint Committee on Taxation scored this legislation last year 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 their investments against risk of loss while still benefitting from low tax rates meant to reward 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 will scrap most current rules and regulations for taxing derivatives in favor of a new, modernized system which will do the following:

Require mark to market and ordinary tax treatment for all derivatives. Sophisticated taxpayers can use derivatives to selectively realize gains or losses to minimize their tax bill. The bill ends selective realizations by requiring mark to market treatment for derivatives, treating these contracts as if they had been sold and repurchased at the end of each year. The bill then requires ordinary tax treatment on the resulting gains and losses. This is the same tax treatment that banks and securities dealers who deal in derivatives get.

Radically simplify the tax rules for derivatives. The bill replaces the current crazy quilt of inconsistent derivative tax rules and instead applies 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 bill repeals nine tax code sections and streamlines many others, including associated regulations. The bill also unifies valuation rules for tax and book purposes.

Target taxpayers who use derivatives to avoid taxes. Sophisticated taxpayers can all but eliminate the risk of stock losses by acquiring the option to sell stock if it falls below a certain price. Because they have not actually sold the stock, they avoid paying taxes on the gains. Under MODA, such taxpayers will be treated as having in effect sold the stock if the derivative price rises at least 70 cents when the stock price drops $1 (a "delta relationship of minus 0.7" in financial parlance), and will owe capital gains taxes. Thereafter, both the derivative *and* the stock will be marked to market with gains taxed at ordinary rates until the derivative is disposed of.

Spare taxpayers hedging risks and trying to comply with a complex code. MODA is aimed at tax avoiders. MODA is not aimed at the banks, businesses, and individuals that hedge business risks; or employees who receive stock options; or derivative transactions in pension funds, endowments, insurance contracts, or annuities; or transactions designed to keep mortgage rates low. Taxpayers using derivatives and struggling to comply with complex straddle rules will now be covered under the simpler MODA rules. The bill also scales back straddle rules so that they only apply to non-derivative hedges that meet the minus 0.7 delta test.