Statement for the Record

On Behalf of the

AMERICAN BANKERS ASSOCIATION

For the Hearing on the

“Financial Products Tax Reform Discussion Draft”

Before the

The Subcommittee on Select Revenue Measures

Of the

House Committee on Ways and Means

March 20, 2013
The American Bankers Association (ABA) is pleased to provide a written statement for the record for the Ways and Means Select Revenue Subcommittee hearing held on March 20, 2013, on the Ways and Means Committee (“the Committee”) financial products tax reform discussion draft (the “Discussion Draft”) released on January 24, 2013.

The ABA represents banks of all sizes and charters and is the voice for the nation’s $14 trillion banking industry and its two million employees.

The Discussion Draft was released in part, as a response to the input and feedback the Committee received during a joint hearing of the Ways and Means Committee and Senate Finance Committee examining the complex relationship between the tax code and financial products, and as “part of the Committee’s broader effort on comprehensive tax reform that significantly lowers rates…seeks to ensure simplicity, transparency and uniformity while modernizing tax rules to prevent scandals.”

The provisions of the Discussion Draft address the following: (1) Provide Uniform Tax Treatment of Financial Derivatives; (2) Simplify Business Hedging Tax Rules; (3) Eliminate “Phantom” Tax Resulting from Debt Restructurings; (4) Harmonize the Tax Treatment of Bonds Traded at a Discount or Premium on the Secondary Market; (5) Increase the Accuracy of Determining Gains and Losses on Sales of Securities; and (6) Prevent the Harvesting of Tax Losses on Securities.

The ABA appreciates the Committee’s efforts to address tax issues relating to financial products/financial institutions as part of a broader discussion on tax reform. Additionally, we appreciate the Committee’s willingness to accept feedback and suggestions as well having the opportunity to comment today. There is no question that our members will be impacted by many of the issues that will be addressed in any discussion on tax reform. Therefore, we hope to be engaged and involved in the process by providing necessary comments or input/feedback on issues impacting our members.

The following reflects our initial comments/feedback on the provisions of the Discussion Draft. If necessary, these comments would be supplemented in a follow up letter to the Committee.

A. Special Rules for Mixed Straddles

The mark-to-market and ordinary treatment rules proposed under the Discussion Draft would apply to all positions in a straddle (generally defined to include all offsetting positions with respect to all property) that includes any “derivative” as defined under the Discussion Draft (see below), even if these positions themselves are not otherwise marked to market (i.e., a mixed straddle).

The Discussion Draft provides a special rule for built-in gains and losses in a non-derivative position that becomes part of a mixed straddle – the only gain or loss in the non-derivative position that is taken into account under the mark-to-market treatment for the relevant year is gain or loss that accrues during the period when the position is part of the mixed straddle.

1. **Acceleration of gain upon entering into the offsetting position**: If the position has a built-in gain at the time of becoming part of the mixed straddle, the position would
be treated as sold for its fair market value at the time of entering into the offsetting position (i.e., creating the mixed straddle).¹

2. **Loss Deferral upon Entering into the Offsetting Position:** In contrast, if the position has a built-in loss at that time, it is not treated as sold at the time of entering into the offsetting position and the amount of the built-in loss is not taken into account in determining the amount that is marked to market during the period of the mixed straddle; 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.

3. The holding period for the derivative position does not include the period during which it is part of a mixed straddle.

The proposed mixed straddle rules expand several existing key provisions in the Code as follows:

1. The definition of the term “straddle” under the Discussion Draft is broader than the current definition under section 1092(c), virtually including all offsetting positions with respect to property. It is unclear whether Congress intends to expand the definition of “straddle” in general or only for this particular purpose. **We suggest that the definition of the term straddle not be expanded as proposed in the Discussion Draft.**

2. Under current mixed straddles rules, one position is normally marked under section 1256, and the other is generally not. The Discussion Draft would repeal this rule by requiring both positions to be marked to market. Thus, this proposal would repeal the current mixed straddle rule and also expand the scope of mark-to-market to positions that currently are not subject to this treatment. **We believe that expansion of mark-to-market to positions other than derivatives is clearly beyond the scope of the Discussion Draft’s intended goal.**

3. The gain trigger rule for positions with built-in gain is an expansion of the current rules of section 1259, because as of today, not all offsetting positions with respect to the built in gain provision would give rise to constructive gain recognition. Thus, significant revisions of section 1259 would be necessary if this rule is adopted. **We suggest that the Committee reconsider expanding section 1259 and allow Treasury and IRS to issue regulations under this section instead.**

4. The proposed loss deferral rule is also an expansion of the current straddle loss deferral rules, and most importantly, seem a-symmetric to the rules pertaining to gains. **We think that if the Committee is to adopt this rule, it should, at least, be symmetrical for gains and losses.**

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¹ Proper adjustment would 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.
B. General Comments on Mark-to-Market

Mark-To-Market Treatment of Financial Derivatives:

This provision expands current mark-to-market rules by requiring all taxpayers engaged in “speculative” financial activity (as opposed to hedging) to mark certain derivative positions to market, thereby triggering the recognition of ordinary gain or loss for tax purposes.

Mark-to-market taxation generally requires yearly valuations and mandates taxation of unrealized gains. Assets held at year end are valued as if they are sold on the last day of each fiscal year. While many commentators have expressed the view that expanding the mark-to-market principle to financial instruments is extremely desirable because of the method’s theoretical correctness, many have cautioned that mark-to-market may not work very well due to problems such as valuation and liquidity. The Discussion Draft does not address these two issues in a way that would help in making further determinations on how well mark-to-market would work under the proposal.

- **Added Complexity** - In the absence of clear guidance, the proposed rules could create more complexity and frustrate the primary objective of the Discussion Draft – simplicity. Therefore, it is important that extensive guidance be provided prior to adoption of any legislation on this topic.

C. Character Issues

Current rules relating to character issues in the area of derivatives are complex, and to some extent, inconsistent. For instance, sections 1234 and 1234A generally apply a “look-through” approach for determining the character of the derivative in accordance with the character of the underlying property, whereas section 1256 provides that the character of gains and losses on section-1256 contracts is capital (60 percent long term and 40 percent short term), regardless of the underlying. Furthermore, sections 475 and 1221(a)(7) require ordinary treatment for derivatives held by dealers and electing traders and for derivatives used for hedging. Finally, specific character rules apply to derivatives in accordance with anti-abuse rules.

- **Comment**: Current inconsistent and complex rules relating to the character of terminations or transfers of positions in derivatives (e.g., section 1234B) will be consolidated and simplified with the proposed ordinary-treatment rule under the Discussion Draft. The consistency and simplicity that would result from the rule would be welcomed by many taxpayers who have been struggling with the inconsistent character rules for derivatives under the various provisions of the Code. Nevertheless, the Committee needs to provide extensive details on how the proposed mark-to-market rules would replace the repealed section 1256 (and regulations thereunder), as such details would be necessary for a smooth transition from the current tax regime for derivatives to the complete ordinary regime proposed in the Discussion Draft. Furthermore, coordination with the provisions pertaining to options and NPCs would be necessary.

- **Comment**: All the mark-to-market gains and losses would be treated as attributable to a trade or business of a taxpayer in accordance with section 172(d)(4) for purposes of determining the amount of nonbusiness deductions which are allowed in computing the taxpayer’s net operating loss. It should be clarified that the provision is not intended to treat all taxpayers subject to the mark-to-market treatment as engaged in a trade or business for
purposes of all other provisions in the Code. In effect, the rule is only limited to the
determination that any mark-to-market loss would not be a miscellaneous itemized
deduction subject to the 2 percent floor.

D. Definition of Derivative

- **Comment:** The Discussion Draft defines derivatives in the broadest sense, thereby
capturing almost every financial position or interest with respect to another underlying asset.
In our view, while the overly broad definition of the term “derivative” is economically
correct and captures the true nature of derivatives, the mark-to-market regime should be
limited to certain types of derivatives (as discussed below). We understand, however, that
the broad definition of derivative serves the purpose of simplicity, consistency and
coherency of the tax rules of derivatives, and limiting it would reduce the benefit of an
overall mark-to-market treatment. Nevertheless, as explained below, due to the liquidity and
valuation concerns, scope limitations are necessary.

E. Embedded Derivatives

- **Comment:** Under the Discussion Draft, a “derivative” would also include any embedded
derivative component of a debt instrument (other than certain foreign currency denominated
debt instruments, contingent payment debt instruments, variable rate debt instruments and
debt instrument subject to alternative payment schedule rules). An “embedded derivative”
for this purpose means any term of a debt instrument that affect some or all of the cash flows
or the value of other payments on the instrument in a manner similar to a derivative (e.g.,
convertible debt). The provision would treat convertible debt as two instruments, non-
convertible debt (not subject to the mark-to-market rule), and an option to acquire stock of
the issuer (subject to mark-to-market). This creation of a new bifurcation treatment for
“embedded derivatives” for tax purposes would complicate current rules, thereby generating
uncertainty and confusion for taxpayers. Moreover, implementation of this rule would
require significant revisions to the current OID rules.

- **We believe that the complexity and uncertainty that would result from the embedded
derivative rules would significantly outweigh any perceived benefits of the rule (e.g.,
achieving more book-tax conformity on the treatment of embedded derivatives).**

F. Fair Market Value

Determination of fair market value has always been a big obstacle for broader adoption of mark-to-
market regime in the U.S. Adoption of the proposed rule would require fair market value
determinations for the taxpayer’s derivative positions. If the value is not readily ascertainable, it
would be determined under the method used by the taxpayer in reports to shareholders, partners,
other proprietors, beneficiaries, or as used for purposes of obtaining credit. Fair market value
would be 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.

- **Comment:** While it is true that many taxpayers must value their positions for GAAP
purposes, as recent cases and IRS guidance have shown, achieving book-tax conformity
with respect to valuation in general, and valuation of derivatives in particular is easier said
than done, often as a result of the sometimes conflicting purposes that financial accounting and tax rules serve.

- In order to address the difficulties that could be raised by valuation, we propose that the Committee limit the scope of derivatives subject to mark-to-market as follows:
  1. Mandate mark-to-market for derivatives that are marked to market for financial accounting purposes, using the fair values determined for financial accounting purposes for tax purposes.
  2. Mandate mark-to-market for publicly traded derivatives using for tax purposes the value of the derivative position as of the last trading day of the year.
  3. Mandate mark-to-market for derivatives that reference publicly traded property (or an index), where the fair market value of the underlying property or index is determinable. This alternative will require valuation of the derivative position based on the value of the underlying property or index.
  4. Allow all other derivatives to be marked to market if the taxpayer elects to do so.

G. Liquidity
Liquidity is another obstacle to a broader application of the mark-to-market rules. It could result in a situation where a taxpayer with an appreciated position at the end of the year is faced with a tax bill without having sufficient funds to pay the tax.

- We propose the following possible solutions to alleviate the liquidity issue:
  1. As suggested above, limit the mandatory mark-to-market treatment for publicly traded derivatives and derivatives that reference publicly traded property, both of which are considered liquid, so that the taxpayer may dispose of some positions to pay the tax.
  2. For other positions that are required to be marked-to-market (primarily those that are marked-to-market for book purposes but are not liquid), allow the taxpayer to defer the gain and pay interest at the federal rate (similar to the PFIC rules).
  3. Alternatively, the Committee may consider allowing taxpayers to spread the gain over a certain period with no interest charge.

Comments on Cost Basis and Wash Sales Provisions

H. Determining Gains and Losses on Sales of Securities

Under existing rules, taxpayers may identify the particular lot of a security to sell in a given transaction or choose a lot selection method, such as “First-in, First-out” (FIFO). With this freedom of choice, the taxpayer has the flexibility to manage gain and loss recognition, as well to avoid inadvertent wash sales. Taxpayers can also simply elect the default method of the broker, often FIFO, but are prohibited from using average basis method except for sales of mutual fund shares.

The relevant Discussion Draft provision would require taxpayers to use the average basis method
for any security sold, exchanged, or otherwise disposed of on or after January 1, 2014. According to the Committee’s Overview of the Discussion Draft, the rationale for eliminating the choices now available to taxpayers is to “To simplify tax compliance and administration, and to determine more accurately the amount of gain or loss when a security is sold…” We support these intentions, but question whether the provision would in fact simplify recordkeeping for taxpayers. In particular, we note the following:

1. The proposal’s requirement that taxpayers use average cost basis method for the sales of securities would be in conflict with the default cost basis method of FIFO and the basis reporting requirements of brokers imposed by the Emergency Economic Stabilization Act of 2008 (EESA). Under the EESA, brokers are only required to track and report in Form 1099-B the basis of “covered securities” purchased after January 1, 2011. Lots of a security purchased before 2011 are “non-covered,” in other words they are not covered by the cost basis reporting rules. Taxpayers would not be able to rely on the average basis information reported by brokers for accounts with both covered and non-covered lots of a security and would have to determine and report in their tax return the average cost basis based on their own records. The IRS would likely receive differing basis information in the broker’s Form 1099-B and in the taxpayer’s return.

2. Average cost basis will require more taxpayer recordkeeping due to the need to recompute the basis for each lot as assets are acquired. The average taxpayer will need to create a complex worksheet that they may use to compute basis, gains and losses.

Under the Single Account Average Cost under Treasury Regulation 1.1012-1(e), the cost basis is calculated based on the average price paid for all shares held, regardless of holding period. Gains or losses are defined as short-term or long-term based on the assumption that the oldest shares are sold first, even though the average cost is the same for all shares – in other words, to use average cost basis the taxpayer must also use FIFO to select the lots sold. The average price for all account shares, both covered and non-covered, is used as the cost basis. Taxpayers would be required to keep separate records that will differ from the broker’s records to track basis for the non-covered assets.

3. As noted above the default lot selection method when using the Single Account Average Cost method is FIFO, therefore the taxpayer will have no control over the selection of assets in order to create long or short term gains. The taxpayer would be forced to sell the oldest lots first.

I. Wash Sales Rules

Under the current wash sale rules, a taxpayer may not recognize a capital loss from the sale of a security, if the taxpayer purchases a substantially identical security within 30 days before or after the date of the sale. The taxpayer may add the disallowed loss to the purchased security’s basis. In addition, IRS guidance has expanded these rules to transactions involving related parties. In particular, a wash sale has occurred if the taxpayer sells a security and the taxpayer’s spouse, Individual Retirement Account (IRA) or a corporation controlled by the taxpayer buys the substantially identical security within the requisite period.
According to the Technical Explanation of the Discussion Draft, the relevant provision would expand the wash sale rules to the taxpayer and these related parties: (1) the taxpayer’s spouse (2) any dependent of the taxpayer and any other 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 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 Committee on Ways and Means has proposed this very complex new set of rules, because “the current law wash sale rule only applies if the same taxpayer sells and reacquires the security, and it can be circumvented using related parties such as spouses, children, or entities controlled by the taxpayer.” There is no doubt that certain taxpayers and their related parties may be attempting to circumvent the wash sale rule, however, it is likely that for many of these taxpayers the wash sale was inadvertent. Despite their inadvertent triggering of the wash sale rules, these taxpayers will now have the considerable burden of having to keep records to satisfy an IRS audit.

An inadvertent wash sale can be illustrated with a separated couple that files their taxes jointly. In such a not so uncommon family situation, one spouse could sell a security at a loss and unbeknownst to him or her, the other spouse has purchased the same security in their 401(k), thereby triggering the wash sale rules. Under the proposed provision, not only is the spouse precluded from taking the capital loss, but also from adding the disallowed loss to his or her basis in the securities that remain in his or her account. Under the proposal, the other spouse who purchased the security in the 401(k) account, for example, would be allowed to add the basis to his or her security. But because a 401(k) is a tax-preferred account and not subject to capital gains tax, the disallowed loss is essentially lost to both taxpayers. Therefore, as some others have suggested, ABA believes the disallowed loss should stay with the original taxpayer who sold the security.

Due to the complexity of the wash sale rules and its ability to trap unsuspecting taxpayers, ABA believes it would be helpful to incorporate a de minimis exception to these rules. Often taxpayers and their brokers must account for wash sales that are mere pennies especially related to assets in a dividend reinvestment program. The disallowed loss to the taxpayer may not be very great, but it nonetheless requires a significant amount of resources by brokers, including banks and trust companies, to keep track of and report on Form 1099-B these marginal amounts. According to a number of our member banks, many wash sale losses are small and often due to the sale of fractional shares.

In closing, the ABA appreciates the opportunity to comment on the Ways and Means financial products tax reform draft and the Committee’s continued focus on tax reform. We look forward to working with you on this proposal and tax reform during the 113th Congress.