TECHNICAL EXPLANATION OF THE WAYS AND MEANS COMMITTEE DISCUSSION DRAFT PROVISIONS TO REFORM THE TAXATION OF FINANCIAL INSTRUMENTS

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Contents

Page

1. Treatment of derivatives (sec. 401 of the discussion draft and new secs. 485 and 486 of the Code)............ 1
2. Treatment of hedges identified for financial accounting purposes (sec. 402 of the discussion draft and sec. 1221 of the Code) 11
3. Determination of issue price in the case of specified debt modifications (sec. 411 of the discussion draft and new sec. 1274B of the Code) 13
4. Deduction for amortizable bond premium allowed in determining adjusted gross income (sec. 412 of the discussion draft and sec. 62 of the Code) 15
5. Current inclusion in income of market discount (sec. 413 of the discussion draft and new sec. 1278 of the Code) 16
6. Rules regarding certain government debt (sec. 414 of the discussion draft and secs. 454, 1037, and 1272A of the Code) 20
7. Cost basis of specified securities determined in accordance with average basis method (sec. 421 of the discussion draft and sec. 1012 of the Code) 21
8. Wash sales by related parties (sec. 422 of the discussion draft and sec. 1091 of the Code) 24

1. Treatment of derivatives (sec. 401 of the discussion draft and new secs. 485 and 486 of the Code)

Present Law

In general

Derivatives are financial instruments the value of which is derived from the value of property, liabilities, or other measures. Common derivatives are options, forward contracts, and swaps. The tax term for a swap is a "notional principal contract." The rules related to the taxation of derivatives apply differently to options, forward contracts, and notional principal contracts. Exceptions to the general rules affect the taxation of derivatives in the case of section 1256 contracts, mark-to-market accounting, and straddles.

Options

An option is a contract between two parties that gives the holder of the option the right, but not the obligation, to buy from, or sell to, the counterparty a specified amount of property at a fixed price (the "strike price") at a specified time or during a specified period. The option holder pays the writer a premium for the option. Traditionally, most options are structured with prepaid premiums. That is, the holder pays the option premium at the inception of the contract. Options may be physically settled, meaning the underlying asset is delivered at settlement, or net cash settled, meaning that one party pays cash at settlement equal to the difference between the strike price of the option and the value of the underlying asset.

In general, gain or loss from options on stock is recognized on an open transaction basis.[1] The option holder capitalizes the cost of the option premium and the option writer does not immediately include it in income.[2] Instead, the amount of gain or loss is determined at the time of a subsequent recognition event, that is, when the option is exercised or sold or when it expires unexercised.[3] Gain or loss attributable to the sale or exchange of an option, or loss attributable to the failure to exercise an option by the purchaser of an option, is considered to have the same character as the property to which the option relates in the hands of the option purchaser (or would have if acquired by the purchaser).[4] Thus, in the case of a purchaser of an option on publicly traded stock as an investment, gain or loss is capital. Different results are obtained if

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[1] Virginia Iron Coal & Coke Co. v. Comm., 37 BTA 195, aff'd., 99 F2d 919 (4th Cir. 1938), cert. denied, 307 US 630 (1939); Rev. Rul. 58-234, 1958-1 CB 279.

[2] See Rev. Rul. 78-182, 1978-1 C.B. 265.

[3] *Ibid.*

[4] Sec. 1234.

the purchaser is a dealer in securities, a taxpayer uses the option as a hedging contract, or a corporation purchases an option on its own stock.[5]

Options that qualify as section 1256 contracts are subject to a mark-to-market regime and special character rules, described below.[6]

For the writer of an option, gain or loss from the termination of the option (other than through delivery of the underlying asset), and any gain on a lapse of the option typically is treated as short-term capital gain or loss, regardless of the term of the contract.[7] In the case of an option writer, gain or loss from delivery typically is capital (unless the option is granted in the ordinary course of the taxpayer's business). However, that gain or loss may be affected by the straddle rules of section 1092, described below.

Forward contracts

A forward contract is a bilateral executory contract pursuant to which the forward buyer agrees to purchase from the forward seller a fixed quantity of property at a fixed price (the "forward price") on a fixed future date (the "delivery date"). In a traditional, postpaid forward contract, neither party to the contract makes a payment at the time the contract is executed; payment and delivery occur on the fixed future date.[8] A prepaid forward contract requires the forward buyer to pay the forward seller the forward price (discounted to present value on the date of the payment) at the time the parties enter into the contract.[9]

A forward contract can represent the forward buyer's expectation that the price of the underlying property will increase and the forward seller's expectation that the price will fall. Like options, forward contracts can be physically settled (settlement by delivery of the underlying asset) or net cash settled (settlement by a payment in cash equal to the difference between the contract price and the then-current price at the time the contract expires) or either, at the option of one of the parties.

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[5] Secs. 475, 1221, and 1032.

[6] A section 1256 contract is any (1) regulated futures contract, (2) foreign currency contract, (3) nonequity option, (4) dealer equity option, and (5) dealer securities futures contract. Sec. 1256(b)(1). The term does not include (1) any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract, or (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. Sec. 1256(b)(2).

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

[8] Although payment of the forward purchase price is not made, the parties may make arrangements for the posting of collateral.

[9] Prepaid forward contracts were relatively uncommon in the markets until the development of publicly traded forward contracts some 20 years ago. See, *e.g.*, Douglas H. Walter and Stephanie E. Balcerzak, "Innovative Transactions: Salomon Phibro Crude Oil Trust," vol. 69 *Taxes* (July 1991), p. 416 (describing the offering of a five-year, oil-based prepaid forward contract by Salomon Brothers and its subsidiary, Phibro Energy, Inc.).

A futures contract is a forward contract that is standardized and traded on an organized futures exchange, such as the Chicago Mercantile Exchange. The exchange acts as the counterparty to every transaction. As a result, every trade on the futures exchange results in two contracts: one between the forward buyer and the exchange, and the other between the forward seller and the exchange. The parties to a futures contract post variation margin, an amount adjusted daily to reflect the extent to which the position of a futures contract buyer or seller is "in the money" (*i.e.*, has an unrealized profit) or "out of the money" (*i.e.*, has an unrealized loss).

The execution of a forward contract generally has no immediate income tax consequences. Like an option, a standard forward contract is an executory contract and is treated as an open transaction until the contract is settled. If a forward contract is settled by delivery of the property underlying the contract, the taxpayer delivering the property recognizes gain or loss based on the difference between the price received and the taxpayer's basis in the property.[10] The forward purchaser, by contrast, reflects the contract price as the basis for the property so acquired; gain or loss (if any) is deferred until the time of a subsequent sale or exchange of the property. The fact that a prepaid forward contract calls for payment by one party to the other party at the time the contract is executed has not been treated as changing the tax treatment of the contract.[11]

The character of the gain or loss with respect to a forward contract generally is the same as the character of the property delivered. If the underlying asset is delivered, the forward buyer does not immediately recognize gain or loss, but is treated as having purchased the property with a basis equal to the purchase price. The forward seller recognizes gain or loss equal to the difference between his basis and the forward price. The character of the forward seller's gain generally depends upon the character of the property delivered.[12] If a forward contract is settled by a cash payment, or is cancelled or otherwise terminated, the gain or loss is capital if the underlying asset is capital in nature.[13] If a forward contract is sold, the character of the gain or loss generally is capital if the forward contract is a capital asset in the hands of the selling taxpayer.

Futures contracts traded on futures exchanges generally are treated as section 1256 contracts and are subject to a mark-to-market regime and special character rules, described below. As applied to equity futures contracts held by investors, the rules of section 1256 apply

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[10] Sec. 1001.

[11] *Cf.* Rev. Rul. 2003-7, 2003-1 C.B. 363 (Feb. 3, 2003) (holding that a shareholder of a publicly traded corporation who entered a variable prepaid forward contract on such stock with an investment bank and pledged the maximum number of shares that might be required to be delivered was not considered to have sold or constructively sold the stock where the amount of stock to be delivered in the future varied significantly depending on the value of the shares on the delivery date, the taxpayer retained an unrestricted legal right to substitute cash or other shares for the pledged shares, and the taxpayer was not economically compelled to deliver the pledged shares).

[12] The character of gain or loss recognized by a forward seller may be affected by the tax straddle and short sale rules of sections 1092 and 1233, respectively.

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

primarily to futures contracts on broad-based indices; single-stock futures contracts are governed by a different set of rules in section 1234B.[14] Different rules can apply to section 1256 contracts held as part of a hedging transaction or a mixed straddle.

Notional principal contracts

Treasury regulations define a notional principal contract (*i.e.*, a swap) as a financial 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.[15] 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. 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. The regulations exclude certain instruments from the definition of notional principal contract including: (1) section 1256 contracts, (2) futures contracts, (3) forward contracts, (4) options, and (5) instruments or contracts that constitute indebtedness for Federal tax purposes.[16]

Regulations promulgated under section 446 require that the parties to a notional principal contract classify each payment pursuant to the contract as either: (i) a periodic payment; (ii) a nonperiodic payment; or (iii) a termination payment.[17] Each type of payment is treated differently for Federal income tax purposes. Taxpayers generally must recognize (as income or deduction, whichever is relevant) the ratable daily portions of all periodic and nonperiodic payments for the taxable year to which that payment relates, and must recognize a termination payment in the year the notional principal contract is extinguished, assigned, or terminated (*i.e.*, in the year the payment is made).[18] A swap with a significant nonperiodic payment is treated as two separate transactions consisting of an on-market level payment swap and a loan.[19] The loan must be accounted for independently of the swap. Under proposed regulations, contingent nonperiodic payments (such as a single payment tied to the increase or decrease in the value of

[14] Section 1234B provides that gain or loss attributable to the sale, exchange, or termination of a securities futures contract shall be considered gain or loss from the sale or exchange of property which 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.

[15] Treas. Reg. sec. 1.446-3(c)(1)(i). The definition of a notional principal contract covers instruments commonly referred to as swaps, but that term is not defined in the Code.

[16] On September 16, 2011, the Treasury Department promulgated proposed amendments to the income tax regulations under sections 1256 and 446 of the Code (Notice of Proposed Rule Making, Fed. Reg. Vol. 76, No. 180, p. 57684). The proposed amendments affect the scope of the term "section 1256 contract" and revise the scope of the notional principal contract regulations under section 446.

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

[18] *Ibid.*

[19] See Treas. Reg. sec. 1.446-3(g)(6), example 3.

the underlying asset) are accrued over the term of the swap based on an estimate of the amount of the payment.[20] The amount of a taxpayer's accrual is redetermined periodically as more information about the expected amount of the noncontingent payment becomes available.[21]

Unlike the character of the income recognized from options and forwards, which typically is determined with reference to the character of gains and losses that result from a taxpayer's transactions with respect to the underlying asset, the character of notional principal contract payments generally is not determined by the character of the underlying asset. Final Treasury regulations do not directly address the tax character of each type of payment made under a notional principal contract. However, proposed Treasury regulations issued in 2004 under section 1234A provide that any payment on a notional principal contract other than a termination payment (*i.e.*, any periodic or nonperiodic payment) generally constitutes ordinary income or expense.[22] The preamble to the proposed regulations explains that ordinary income is warranted because neither periodic nor nonperiodic payments involve the sale or exchange of a capital asset. In contrast, the proposed regulations provide that, by application of section 1234A, gain or loss attributable to the termination of a notional principal contract is capital if the contract is a capital asset in the hands of the taxpayer.[23] The proposed regulations state that final settlement payments with respect to a notional principal contract are not termination payments under section 1234A.[24]

Section 1256 contracts

Section 1256 provides special timing and character rules for a contract identified as a section 1256 contract. Any gain or loss with respect to a section 1256 contract is subject to a mark-to-market timing rule. The character of gain or loss (if not otherwise ordinary) is determined under the 60/40 rule. That is, it is treated as long-term capital gain or loss, to the extent of 60 percent of the gain or loss, and short-term capital gain or loss, to the extent of the remaining 40 percent of the gain or loss regardless of the taxpayer's holding period.[25] Gain or loss is recognized upon the termination (or transfer) of a section 1256 contract, by offsetting, by

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[20] See Prop. Treas. Reg. sec. 1.446-3.

[21] *Ibid.*

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

[23] The proposed regulations treat any payment on a "bullet swap" or forward contract, including payments made pursuant to the terms of the contract, as termination payments for purposes of Section 1234A. Both of these types of contracts provide for all payments to be made at or close to the maturity of the contract. Prop. Treas. Reg. sec. 1.1234A-1(c). More recent proposed amendments to the income tax regulations under sections 1256 and 446 call into question this analysis. Among other things, the proposed amendments treat the fixing of an amount as a "payment" for purposes of the definition of a notional principal contract, even if the actual payment reflecting that amount is to be made at a later date.

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

[25] 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.

taking or making delivery, by exercise or by being exercised, by assignment or being assigned, by lapse, or otherwise, and generally is treated as 60 percent long-term capital and 40 percent short-term gain or loss.[26] A taxpayer other than a corporation may elect to carry back its net section 1256 contract losses for three taxable years.[27]

A section 1256 contract is defined as any (1) regulated futures contract, (2) foreign currency contract, (3) nonequity option, (4) dealer equity option, and (5) dealer securities futures contract.[28] The term section 1256 contract does not include (1) any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract, or (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.[29]

Mark-to-market accounting for dealers and traders

Certain types of taxpayers (*e.g.*, dealers) with certain types of contracts (*e.g.*, regulated futures contracts, foreign currency contracts) are required to recognize the gain or loss with respect to those unsettled financial contracts as if the transactions were completed on the last day of the tax year, if not more frequently.

Section 475 requires mark-to-market accounting for dealers in securities and for certain traders in securities and traders and dealers in commodities who elect into section 475.[30] To the extent a dealer is holding the security as inventory, the security must be carried in inventory at fair market value with any gains and losses recorded at such time.[31] All resulting mark-to-market gain or loss with respect to such securities generally is treated as ordinary gain or loss.[32] For all other securities held by a dealer, the transaction is deemed completed on the last day of the tax year for purposes of reporting a gain or loss.[33] However, mark-to-market accounting is not permitted for securities held by dealers for investment, acquired in the taxpayer's ordinary course of business and not held for sale, or which are hedges unrelated to securities held by the dealer as inventory.[34]

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

[27] Sec. 1212(c).

[28] Sec. 1256(b).

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

[30] See also Caginalp, Connors, and Handler, 543 T.M., *The Mark-To-Market Rules of Section 475*, Tax Management Portfolio No. 543.

[31] Sec. 475(a)(1).

[32] Sec. 475(d)(3).

[33] Sec. 475(a)(2).

[34] Sec. 475(b). See also section 475(d) regarding improperly identified securities.

While mark-to-market accounting is mandatory for the abovementioned taxpayers, dealers with financial interests in commodities and traders with financial interests in securities and/or commodities may elect to recognize their gains and losses in accordance with section 475.[35] That is, if an election is made, gains or losses related to changes in the market value of commodities and securities for traders and dealers may be recognized as if the contract had closed as of the last day of the tax year.

Straddles

Where taxpayers create artificial losses by entering into transactions with offsetting positions such that the underlying economics are not altered, the straddle rules under section 1092 defer all or a portion of the loss that would otherwise be recognized.[36] Section 1092 prevents taxpayers in a "straddle" from selectively recognizing gains and losses (*i.e.*, without section 1092, a taxpayer could recognize the tax loss on one position in the current tax year while simultaneously deferring tax recognition of the gain in the opposing position until a later taxable year). Instead, the loss is deferred to the extent of the unrealized gain in the offsetting position of the straddle. Section 1092, and the regulations promulgated thereunder, address straddle character issues by preventing the conversion of short-term capital gain into long-term capital gain with special holding period rules[37] and character rules.[38]

The rules of section 1092 do not apply to hedging transactions,[39] straddles composed entirely of section 1256 contracts,[40] or qualified covered calls.[41] Special rules apply for mixed straddles (generally, straddles composed of both section 1256 contracts and non-section 1256 contracts)[42] and for identified straddles.[43]

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[35] Sec. 475(f).

[36] In general, the taxpayer holds two opposing economic positions in the same property that perform in divergent manners, as opposed to transactions in which a taxpayer "goes long" or " goes short" a particular position.

[37] Sec. 1092(b) and Treas. Reg. sec. 1.1092(b)-2T(a).

[38] Sec. 1092(b) and Treas. Reg. sec. 1.1092(b)-2T(b)(1).

[39] Sec. 1092(e).

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

[41] Sec. 1092(c)(4). For this purpose, section 1092(c)(4) defines a qualified covered call to mean an option granted by the taxpayer to purchase stock held (or acquired) by the taxpayer, and meeting several additional criteria. These include that the option is traded on a registered exchange, that it is granted more than 30 days before the date it expires, that it is not a deep-in-the-money option, that it is not granted by an options dealer in connection with his option dealing activity, and that gain or loss with respect to the option is not ordinary gain or loss.

[42] Sec. 1092(b)(2). If a straddle consists of both positions that are section 1256 contracts and positions that are not such 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 rules written under regulations to prevent the deferral of tax or the conversion of short-term capital gain to long-term capital gain or long-term capital loss into short-term capital loss.

Explanation of Provision

In general

Under the provision, gain or loss from derivatives generally must be reported on an annual basis under a mark-to-market rule. Each derivative held by a taxpayer is treated as if it were sold on the last business day of the year for its fair market value, and any resulting gain or loss is taken into account for such taxable year. All resulting mark-to-market gain or loss with respect to a derivative is treated as ordinary gain or loss and is treated, for purposes of determining the amount of nonbusiness deductions which are allowed in computing a net operating loss, as attributable to a trade or business of the taxpayer.

If a taxpayer holds a derivative contract at the beginning of the taxable year, proper adjustment must be made to any gain or loss subsequently realized with respect to such contract to reflect any gain or loss taken into account by such taxpayer in a prior year.

The mark-to-market rules of the provision, including the treatment of gain or loss as ordinary, also apply to the termination or transfer during the taxable year of a taxpayer's rights or obligations with respect to a derivative by offsetting, by taking or making delivery, by exercise or being exercised, by assignment or being assigned, by lapse, by expiration, by settlement, or otherwise. Fair market value for such terminations or transfers is determined at the time of the termination or transfer.

These mark-to-market rules apply to all derivatives held by a taxpayer, notwithstanding that nonrecognition of gain or loss would result from the application of any other provision of the Code.

Adoption of a mark-to-market regime for derivatives requires that the fair market value of the derivative be determined on each relevant date as necessary to include in income for the taxable year the derivative gains and losses. To the extent provided in regulations, if the fair market value of a derivative is not readily ascertainable, then value is determined under the method used by the taxpayer in reports to shareholders, partners, other proprietors, beneficiaries, or as used for purposes of obtaining credit. To the extent provided in regulations, fair market value is 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.

Definition of derivative

For purposes of the provision, a derivative is (1) any evidence of an interest in, or any derivative instrument with respect to, any (a) share of stock in a corporation, (b) partnership interest or beneficial ownership interest in a partnership interest or trust, (c) note, bond, debenture, or other evidence of indebtedness, (d) certain real property, (e) actively traded commodity, or (f) currency; (2) any notional principal contract; and (3) any derivative instrument with respect to any interest or instrument described above.

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[43] Sec. 1092(a)(2).

For purposes of the provision, a derivative instrument includes any option, forward contract, futures contract, short position, swap, or similar instrument. A notional principal contract is any instrument requiring two or more payments at specified intervals calculated by reference to a specified index upon one or more notional amounts. So as not to exclude a contract that merely rolls more than one interim payment or price adjustment into a single contract payment, the provision specifies that an amount shall not fail to be treated as a "payment" for this purpose merely because the amount is fixed on one date but paid (or otherwise taken into account) on a different date.

A specified index is any one or more of (or any combination of) (1) a rate, price, or amount (whether fixed or variable); (2) any index based on any information that is not in the control of any of the parties to the instrument and not unique to any of the parties' circumstances; and (3) any other index as the Secretary may prescribe.

The provision excludes from the definition of a derivative certain interests or instruments with respect to real property. An interest or instrument is not a derivative if it is either (1) with respect to a tract of real property as defined in section 1237(c), or (2) with respect only to real property which would be inventory if held directly by the taxpayer. The Secretary is directed to prescribe regulations or other guidance under which multiple tracts of real property may be treated as a single tract of real property for this purpose if the interest or instrument is of a type designed to facilitate the acquisition or disposition of such real property.[44]

The definition of a derivative is intended to be broad. For example, the term encompasses an option, a forward, or a futures contract with respect to any stock, partnership interest, or debt regardless of whether the contract or interest (or the underlying contract or interest) is privately held or publicly traded. The term includes such positions as short sales and short securities futures contracts. In addition, the provision's definition of a notional principal contract is broader than the definition under current Treasury regulations.[45] For example, the provision's definition of a specified index includes indexes other than those based on objective financial information, such as temperature, precipitation, snowfall, or frost.

In some cases, an instrument qualifies as a derivative under more than one prong of the definition. For example, the proper categorization under present law of a credit default swap has been subject to some uncertainty. In general, a simple credit default swap is a contractual arrangement in which one party buys from another party protection against default by a particular obligor with respect to a particular obligation. Simple credit default swaps have been analogized to notional principal contracts or contingent put options (as well as insurance). It is intended that a credit default swap be treated as a derivative either because it represents an option with respect to a debt instrument or because it qualifies as a notional principal contract.

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[44] The provision is intended to allow a narrow exclusion from the mark-to-market rule for contracts related to single pieces of real estate and for contracts related to real estate held for sale by real estate developers.

[45] See Treas. Reg. Sec. 1.446-3.

Under the provision, a derivative generally includes any embedded derivative component of a debt instrument. If a debt instrument has an embedded derivative component, the instrument generally is treated as two separate instruments, a derivative that is subject to the provision and a debt instrument that is not. For this purpose, an embedded derivative component means any terms of a debt instrument that affect some or all of the cash flows or the value of other payments required by the instrument in a manner similar to a derivative. One example of a debt instrument with an embedded derivative component is debt that is convertible into the stock of the issuer. The provision treats this 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 the mark-to-market rule). However, a debt instrument is not treated as having an embedded derivative component merely because the debt instrument is denominated in or specifies payments by reference to a nonfunctional currency, is a contingent payment debt instrument or variable rate debt instrument, or has an alternative payment schedule.

Mixed straddles

The mark-to-market and ordinary treatment rules of the provision apply to all positions in a straddle that includes any derivative to which the provision applies, even if these positions are not otherwise marked to market (*i.e.*, a mixed straddle). In addition, special rules apply to positions not otherwise marked-to-market that become part of a mixed straddle. If the position has a built-in gain, the position is treated as sold for its fair market value at the time of entering the mixed straddle. Proper adjustment must 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. If the position has a built-in loss, the position is not treated as sold at the time of entering the mixed straddle 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. The holding period for the position does not include the period during which it is part of a mixed straddle. A consequence of the special rules for built-in gains and losses in a non-derivative position that becomes part of a mixed straddle is that the only gain or loss in the non-derivative position that is taken into account under the mark-to-market regime is gain or loss that accrues during the period when the position is part of a mixed straddle.

Hedging exception

The provision's special rules for the treatment of derivatives do not apply to any derivative that is part of a hedging transaction (as defined in section 1221(c)).[46]

The provision repeals superceded rules for determining capital gains and losses under sections 1234B, 1236, and 1256.

[46] See the description of sec. 402 of the discussion draft for the rules applicable to hedging transactions.

Effective Date

The provision applies to property acquired and positions established after December 31, 2013.

2. Treatment of hedges identified for financial accounting purposes (sec. 402 of the discussion draft and sec. 1221 of the Code)

Present Law

In general

Capital gain treatment applies to gain on the sale or exchange of a capital asset. The term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include property that is part of a hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe).[47] Gain or loss on property that is part of an identified hedging transaction generally is treated as ordinary, rather than capital.[48]

A hedging transaction is defined as any transaction entered into by the taxpayer 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 which is held or to be held by the taxpayer, to manage risk of interest rate or 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 to manage other risks as prescribed under Treasury regulations.[49]

Hedge identification requirement

The regulations issued under section 1221 require that in order to qualify for hedge transaction tax treatment, a taxpayer that enters into a hedging transaction must clearly identify the transaction as a hedging transaction before the close of the day on which the taxpayer acquired, originated, or entered into the transaction.[50] In order to qualify for hedge transaction tax treatment, a taxpayer that enters into a hedging transaction must also identify the item, items, or aggregate risk being hedged. Identification of an item being hedged generally involves indentifying a transaction that creates risk, and the type of risk that the transaction creates.[51]

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[47] Sec. 1221(a)(7).

[48] Certain other Code sections also treat gains or losses as ordinary. For example, the gains or losses of securities dealers or certain electing commodities dealers or electing traders in securities or commodities that are subject to "mark-to-market" accounting are treated as ordinary (sec. 475).

[49] Sec. 1221(b)(2)(A).

[50] Treas. Reg. Sec. 1.1221-2(f)(1).

[51] Treas. Reg. Sec. 1.1221-2(f)(2).

Additional information is required for certain types of hedging transactions.[52] The regulations also specify that the identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy the identification requirement unless the taxpayer's books and records indicate that the identification also is being made for tax purposes. However, the taxpayer may indicate that individual hedging transactions or a class or classes of hedging transactions that are identified for financial accounting or regulatory purposes also are being identified as hedging transactions for tax purposes.[53]

Financial accounting hedge identification requirement

Under U.S. Generally Accepted Accounting Principles ("GAAP"), there are rules applicable to accounting for hedging transactions, which have the effect of matching the timing of the income recognition of an instrument used as a hedge with that of the hedged item.[54] These financial accounting rules have a hedge identification requirement similar though not identical to the Federal tax requirement contained in the section 1221 regulations. To qualify for hedge accounting for financial accounting purposes, a formal identification must be made at the inception of a hedge,[55] including documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. The documentation must include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged, and information for assessing the hedging instrument's effectiveness.

Explanation of Provision

Under the provision, a hedging transaction is treated as meeting the hedge identification requirement under section 1221 if the transaction is identified as a hedging transaction for tax purposes (as required under existing law), or if the transaction is treated as a hedging transaction within the meaning of GAAP for purposes of the taxpayer's audited financial statement. The audited financial statement must be certified as being prepared in accordance with GAAP by an

[52] Treas. Reg. Sec. 1.1221-2(f)(3) details additional requirements for anticipatory asset hedges, inventory hedges, hedges of debt of the taxpayer, hedges of aggregate risk, and transactions that counteract hedging transactions.

[53] Treas. Reg. Sec. 1.1221-2(f)(4)(ii).

[54] Financial Accounting Standards Board Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, now codified into Accounting Standards Codification ("ASC") 815. For financial accounting purposes, the income recognition of the hedging instrument and the hedged item are generally matched by marking both the hedging instrument and the hedged item to market.

[55] The purpose of the requirement to identify and document the hedge at inception is to prevent a company from using hindsight in applying hedge accounting. ASC 815-20-25-3 states, "Concurrent designation and documentation of a hedge is critical; without it, an entity could retroactively identify a hedged item, a hedged transaction, or a method of measuring effectiveness to achieve a desired accounting result."

independent auditor and must be used for the purposes of a statement or report to shareholders, partners, or other proprietors, or to beneficiaries, or for credit purposes.[56]

A transaction treated as a hedging transaction for purposes of an audited financial statement is treated as a hedging transaction for tax purposes, as long as the transaction also meets the substantive definition of a tax hedging transaction, which is unchanged by the provision. If a transaction identified as a hedging transaction for purposes of an audited financial statement does not meet the definition of a hedging transaction for tax purposes, the taxpayer is not permitted to use hedge accounting for the transaction in its tax return. The rules under Treasury regulations for improper identification of a hedging transaction are not applicable to a hedge which is identified as a hedging transaction for financial statement purposes, but does not qualify as a hedging transaction for tax purposes, unless the taxpayer improperly treats the transaction as a tax hedging transaction in its tax return for the taxable year which includes such transaction.

Effective Date

The provision applies to transactions entered into after December 31, 2013.

3. Determination of issue price in the case of specified debt modifications (sec. 411 of the discussion draft and new sec. 1274B of the Code)

Present Law

Treatment of issuer

Gross income includes income from the cancellation of indebtedness ("COD").[57] The amount of COD income is generally the difference between the adjusted issue price[58] of the debt being cancelled and the amount used to satisfy the debt.[59] The COD rules generally apply to the exchange of an old debt obligation for a new debt obligation, including a modification of the old debt that is treated as an exchange.[60] In the case of an old obligation that is exchanged for a new

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[56] Taxpayers who do not prepare audited financial statements under GAAP may not identify hedging transactions based on a financial statement identification.

[57] Sec. 61. Section 108 provides that in the case of an insolvent debtor or debtor in bankruptcy, instead of including the amount in gross income, certain tax attributes are reduced. Present law provides an exclusion relating to qualified principal residence indebtedness which is not affected by the discussion draft.

[58] Treas. Reg. 1.1275-1(b) provides that the adjusted issue price is the issue price increased by the amount of OID previously includible in gross income of any holder and decreased by payments other than payments of stated interest.

[59] Treas. Reg. 1.61-12(c)(2).

[60] See. Treas. Reg. sec. 1.1001-3(a).

obligation, for purposes of determining the amount of COD, the amount used to satisfy the old obligation is the issue price of the new obligation.[61]

If the issue price of the new debt obligation exceeds the adjusted issue price of the old debt obligation, the issuer has retirement premium which is immediately deductible if either debt obligation is publicly traded or, if not, the issuer reduces the issue price of the new debt and the premium is amortized over the term of the new debt.[62]

Treatment of holder

The holder of an existing debt instrument exchanged for a new debt instrument generally recognizes gain or loss to the extent the adjusted basis of the existing debt differs from the sum of money and fair market value of any property received (including the new debt).[63] The issue price of the new debt obligation generally determines the amount realized by the holder of the old debt.[64] In the case of a corporate reorganization and certain corporate distributions, gain on the exchange of securities is recognized only to the extent of the fair market value of the excess of the principal amount of the securities received over the principal amount of the securities surrendered[65] and loss on the exchange is not recognized.[66]

Issue price of new obligation

The issue price of the new obligation is determined under the general rules applicable to a debt instrument issued for property.[67] If the new debt is publicly traded, the issue price is the fair market value of the debt. If the new debt is not publicly traded, but the old debt is publicly traded, the issue price is the fair market value of the old debt. If neither debt is publicly traded, the issue price of the new debt is its stated redemption price at maturity if the debt has adequate stated interest, generally based on the applicable Federal rate ("AFR"). If the new debt does not have adequate stated interest, the issue price is an imputed principal amount using the applicable AFR as the discount rate.

Prior to the Omnibus Budget Reconciliation Act of 1990, the Code provided a special rule for the determination of issue price in the case of exchange of debt instruments in a corporate reorganization. The special rule generally provided that in a corporate reorganization

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[61] Sec. 108(e)(10).

[62] Treas. Reg. sec. 1.163-7(c).

[63] Sec. 1001 and Treas. Reg. sec. 1.1001-1.

[64] Treas. Reg. sec. 1.1001-1(g)(1).

[65] Sec. 356(d)(2)(B) and (C).

[66] Sec. 356(b).

[67] Secs. 1273(b) and 1274.

the issue price of the new debt instrument would not be less that the adjusted issue price of the old debt instrument. The 1990 Act repealed the special rule.[68]

Explanation of Provision

The provision provides that in the case of any specified debt modification, the issue price of the modified debt instrument is the lesser of (i) the adjusted issue price of the existing debt instrument, or (ii) the issue price of the modified debt instrument which would be determined under section 1274 if the debt instrument were a debt instrument to which that section applied (*i.e.,* the principal amount if there is adequate stated interest or, otherwise, the imputed principal amount). If the principal amount of the debt does not change, the debt modifications will not cause the issuer to recognize COD income. Because the new debt is subject to section 1274, COD cannot be avoided by forgiving interest rather than principal on an outstanding debt.

A specified debt modification means (i) an exchange by the issuer of a new debt instrument for an existing debt instrument of the issuer, or (ii) the amendment of an existing debt instrument, including a significant modification of an existing debt instrument which is accomplished by the issuer and the holder indirectly through one or more transactions with unrelated parties. The provision is not intended to change the current regulation's definition of when a significant modification of a debt instrument constitutes an exchange.[69]

For example, if a publicly traded debt instrument with a redemption price and an adjusted issue price of $10,000 is exchanged for a new debt instrument with a redemption price of $10,000 (and adequate stated interest) with an extended maturity, the issue price of the new debt is $10,000 regardless of the fair market value of the old debt. Thus, the issuer will not have any COD income.

Effective Date

The provision applies to transactions after December 31, 2013.

4. Deduction for amortizable bond premium allowed in determining adjusted gross income (sec. 412 of the discussion draft and sec. 62 of the Code)

Present Law

Under present law, a deduction for amortizable bond premium is allowed to the holder of a taxable bond acquired for more than the amount payable on maturity.[70] The deduction is not allowed in computing adjusted gross income.[71] The amount amortizable is computed on a

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[68] Sec. 1275(a)(4) was repealed by section 11325(a)(2) of the Omnibus Budget Reconciliation Act of 1990.

[69] See Treas. Reg. 1.001-3 for the test when a significant modification occurs.

[70] Sec. 171(a)(1).

[71] Sec. 62.

constant yield basis. The amount of bond premium is allocated among the interest payments received on the bond, and the allocated amount reduces the amount the of the interest payments to the extent thereof in lieu of any deduction otherwise allowable.[72]

Explanation of Provision

The provision allows the deduction for amortizable bond premium of an individual as an "above-the-line" deduction which reduces adjusted gross income.

Effective Date

The provision applies to taxable years beginning after December 31, 2013.

5. Current inclusion in income of market discount (sec. 413 of the discussion draft and new sec. 1278 of the Code)

Present Law

If a bond declines in value after it is originally issued, the purchaser of the bond will acquire it with market discount. The decline in value may occur because general interest rates have risen, because the creditworthiness of the issuer has declined, or both. A taxpayer who purchases a bond after original issue at a price less than its principal amount (or adjusted issue price in the case of a bond originally issued at a discount) does not, absent an election, include in income any portion of the market discount prior to the disposition of the bond.

Market discount that accrues while the taxpayer holds a bond is treated as ordinary income, rather than capital gain, upon the disposition of the bond.[73] The amount treated as ordinary income does not exceed the amount of gain recognized on the disposition of the bond. Market discount accrues on a ratable basis unless the taxpayer elects to accrue on the basis of a constant interest rate. A de minimis rule treats the amount of market discount as zero if the market discount is less than one quarter of one percent of the stated redemption price times the number of complete remaining years to maturity after the bond is acquired by the taxpayer.[74]

Interest expense on indebtedness incurred or continued to purchase or carry a bond with market discount is allowed as a deduction for a taxable year only to the extent the interest expense exceeds the market discount accruing on the bond in that year.[75] The taxpayer may elect to treat any interest expense disallowed in a prior taxable year as interest expense accruing in the current taxable year to the extent of the net interest income with respect to the bond.[76] To the

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[72] See Treas. Reg. sec. 1.171-2 for rules relating to offsetting qualified stated interest with premium.

[73] Sec. 1276.

[74] Sec. 1278(a)(2)(C).

[75] Sec. 1277.

[76] Sec. 1277(b)(1).

extent any interest expense has been previously disallowed, it is allowed at the time the market discount is recognized.[77]

A taxpayer may elect to include market discount in income as it accures.[78] If an election is made, the amount included in income is generally treated as interest. However, market discount on a state or local bond is not treated as interest and therefore not exempt from taxation. Similarly market discount realized by a foreign person is not treated as interest for purposes of determining the foreign person's U. S. tax liability under sections 871(a), 881, 1441 and 1442. Consequently, market discount not effectively connected with a U. S. trade or business is treated as gain from the sale of personal property and sourced in accordance with the rules of section 865. Thus, foreign persons generally are not subject to U. S. tax on market discount not effectively connected with a U. S. trade or business.

Original issue discount (OID), unlike market discount, is includible in income of the holder currently using a constant interest rate.[79] OID is discount arising on the issuance of a bond for less than its principal amount. For example, if a publicly traded bond with a principal amount of $1,000 is issued for $800, the bond has $200 OID. OID is deductible by the issuer of the debt instrument over the term of the instrument, whereas the issuer is not impacted by market discount.

Amounts of OID includible in gross income in excess of $10 for one year on bonds for a term of more than one year must be reported to the bond holder by the issuer or broker from whom the bond was acquired.[80] In addition, brokers are required to report gross proceeds from sale or disposition of bonds, as well as the adjusted basis in covered securities, and furnish copies of these reports or statements to their customers.[81] Also, a person who transfers a bond to a broker is required to provide a statement to the transferee reflecting information necessary for the broker to comply with his information reporting obligations.[82]

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[77] Sec. 1277(b)(2).

[78] Sec.1278(b).

[79] Sec. 1272(a).

[80] Sec. 6049(a), (d)(6); Treas. Reg. sec. 1.6049-4(a) *et seq*. See, generally, Internal Revenue Service, *Guide to Original Issue Discount (OID) Instruments*, Pub. 1212, (12/2011); Internal Revenue Service, *Investment Income and Expenses,* Pub. 550, chapter 1, "Market Discount Bonds."

[81] A covered security is any debt instrument that has OID or market discount that was acquired after 2013 through a broker or transferred from a broker with a statement prescribed by the Code with respect to the transfer, if the recipient of the interest or proceeds is not an exempt recipient. Sec. 6045(g)(3); Treas. Reg. sec. 1.6045-1(c)(3), defining exempt recipient.

[82] Sec. 6045A.

Explanation of Provision

In general

Current inclusion of market discount accruals

Under the provision, the holder of a market discount bond acquired after December 31, 2013, includes in gross income currently the sum of the daily portions of the market discount for each day during the taxable year that the taxpayer holds the bond. The amount of the inclusion for any taxable year is computed on the basis of a constant interest rate. The amount included in gross income is generally treated as interest, with the same exceptions that apply under present law where an election to accrue market discount has been made.

The daily portion of market discount on any market discount bond is the amount that would be the daily portion determined for an original issue bond if, on the acquisition date, the bond had been issued for a price equal to the adjusted basis of the bond immediately after its acquisition. The daily portion of market discount is adjusted to exclude the daily portion of any OID on the bond so as to prevent a double inclusion of OID.

Limitation of market discount accruals

The amount of discount includible in gross income by reason of this provision with respect to any bond shall not exceed the amount that would be so includible if the basis of the bond immediately after its acquisition was the imputed principal amount determined by using a discount rate equal to the greater of (i) an amount equal to the bond's yield to maturity (determined as of the date of the issuance) plus five percentage points or (ii) an amount equal to the applicable Federal rate for the bond (determined at the time of acquisition) plus ten percentage points. Thus, the interest includible in income cannot exceed the greater of the amounts determined above based on the acquisition price.

Other rules

The adjusted basis of the bond is increased by amounts included in gross income of the holder of a bond under this provision.

In the case of a bond held by a partnership with respect to which a transfer of a partnership interest occurs by sale or exchange or by reason of death, the market discount rules apply to the transferee partner as if any bond held by the partnership was acquired at the time of the transfer (and the basis of the bond for purposes of determining market discount shall be determined after any adjustment under section 743).

The market discount provisions of present law (sections 1276 (treatment of gain), 1277 (deferral of interest deduction), and 1278(b) (election for inclusion)) do not apply to any bond to which this provision applies. This provision does not apply to bonds having original issue discount which were issued before July 2, 1982.

The provision repeals the special rules for short-term non-governmental obligations held by taxpayers subject to current inclusion, which require the accrual of original issue discount but not market discount.[83]

Brokers who hold a "covered bond" are required to report includible OID and market discount with respect to such bonds to the IRS and the customer. A covered bond is any debt instrument that has OID or market discount that was acquired after 2013 through a broker or transferred from a broker with a statement prescribed by the Code with respect to the transfer. In addition, persons who transfer a covered bond are required to provide the transferee with a statement in sufficient detail to permit the transferee to comply with its obligation to report market discount. Finally, to the extent that there may be duplicative reporting obligations with respect to OID, the obligations under this provision take precedence except to the extent provided in guidance from the Secretary.

Example

On January 1, 2014, XYZ Corporation issues a $1,000 ten-year publicly-traded bond with a five percent coupon, with $50 of interest paid annually on December 31 of each calendar year. The bond is issued for $960, with original issue discount of $40. Bondholders accrue original issue discount based on the bond's yield to maturity at issuance.[84] XYZ Corporation deducts this amount of original issue discount over the life of the bond. The annual yield to maturity at the time the bond is issued is 5.53 percent.[85]

On January 1, 2016, Taxpayer buys the bond in the secondary market for $950. In addition to original issue discount, Taxpayer accrues market discount under the provision based on the calculated annual yield to maturity for the bond based on Taxpayer's adjusted basis of $950, which is 5.80 percent. On December 31, 2016, Taxpayer has income of $55.09 ($950 multiplied by .0580), of which $50 represents stated interest, $3.45 represents accrued original issue discount, and $1.64 represents accrued market discount. The accrued original issue discount and accrued market discount are added to the basis of the bond. For 2016, Taxpayer has total ordinary income of $55.09 and adjusted basis of $955.09.

[83] Sec. 1283(c).

[84] Assume that a bond is issued at a price P_0, pays an annual coupon i, and is redeemable in N years for a price of one dollar. The yield to maturity (r) is the solution to the following equation: $P_0 = \frac{i}{r}\left[1 - \frac{1}{(1+r)^N}\right] + \frac{1}{(1+r)^N}$.

[85] Regulations permit rounding to two decimal places. The numbers appearing in the text and the table were rounded to two decimal places at the final stage. Calculations may vary if a different rounding convention is used.

Taxpayer holds the bond to maturity and receives $1,000 on December 31, 2024. Over the time it holds the bond, Taxpayer accrues $50 total in discount ($1,000-$950), including $33.63 of original issue discount[86] and $16.37 of market discount.

The table below summarizes the annual income inclusions for Taxpayer.

Year	Adjusted Basis as of January 1	Stated Interest	Original Issue Discount	Market Discount	Total Ordinary Income
2016	$950.00	$50.00	$3.45	$1.64	$55.09
2017	$955.09	$50.00	$3.65	$1.73	$55.38
2018	$960.47	$50.00	$3.85	$1.85	$55.70
2019	$966.17	$50.00	$4.06	$1.97	$56.03
2020	$972.20	$50.00	$4.28	$2.10	$56.38
2021	$978.58	$50.00	$4.52	$2.23	$56.75
2022	$985.33	$50.00	$4.77	$2.37	$57.14
2023	$992.47	$50.00	$5.05	$2.48	$57.53
TOTAL	$1,000.00	$400.00	$33.63	$16.37	$450.00

Effective Date

The provision applies to debt obligations acquired after December 31, 2013.

6. Rules regarding certain government debt (sec. 414 of the discussion draft and secs. 454, 1037, and 1272A of the Code)

Present Law

Present law provides that a cash-basis taxpayer holding a non-interest bearing obligation issued at a discount may elect to include in income the increase in the value of the obligation.[87]

Present law provides that discount on certain short-term government obligations, such as Treasury bills, is not considered to accrue until the obligation is paid at maturity or otherwise disposed of.[88] However, in the case of a taxpayer using an accrual method of accounting and certain other taxpayers, discount on short-term obligations is required to be included currently in income.[89]

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[86] At the time Taxpayer acquired the bond, the bond had accrued, and XYZ Corporation had deducted, $6.37 in original issue discount. Thus, over the life of the bond, all bondholders accrue, and XYZ Corporation deducts, the full $40 in original issue discount.

[87] Sec. 454(a).

[88] Sec. 454(b).

[89] Sec. 1281(a).

Any increase in the redemption value of a United States savings bond (to the extent not previously included in income) is includible in gross income in the taxable year the bond is redeemed or the taxable year of final maturity, whichever is earlier.[90]

Present law provides that United States obligations may be exchanged without recognition of gain or loss.[91] At one time, this provision allowed an individual to exchange Series E or EE savings bonds for Series H or HH savings bonds without recognition of income. The Treasury Department no longer issues Series H or HH savings bonds.[92]

Explanation of Provision

The provision moves the rules relating to the tax treatment of United States savings bonds to the portion of the Internal Revenue Code of 1986 relating generally to the treatment of bonds and other debt instruments. The provision does not change the present-law tax treatment of United States savings bonds.

The provision repeals the provision of present law relating to the accrual of interest on short-term government obligations.

The provision repeals the provision allowing the tax-free exchange of certain United States obligations.

Effective Date

The provision is generally effective on the date of enactment.

The repeal of the provision allowing tax-free exchanges of certain obligations applies to exchanges after December 31, 2013.

7. Cost basis of specified securities determined in accordance with average basis method (sec. 421 of the discussion draft and sec. 1012 of the Code)

Present Law

In general

Gain or loss generally is recognized for Federal income tax purposes on realization of that gain or loss (for example, through the sale of property giving rise to the gain or loss).[93] The

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[90] Sec. 454(c).

[91] Sec. 1037.

[92] The last series HH savings bonds were issued in August, 2004.

[93] *See, e.g., Helvering v. Bruun*, 309 U.S. 461, 469 (1940).

taxpayer's gain or loss on a disposition of property is the difference between the amount realized and the adjusted basis.[94]

To compute adjusted basis, a taxpayer must first determine the property's unadjusted or original basis and then make adjustments prescribed by the Code.[95] The original basis of property is its cost, except as otherwise prescribed by the Code (for example, in the case of property acquired by gift or bequest or in a tax-free exchange). Once determined, the taxpayer's original basis generally is adjusted downward to take account of depreciation or amortization, and generally is adjusted upward to reflect income and gain inclusions or capital outlays with respect to the property.

Basis computation rules

If a taxpayer has acquired stock in a corporation on different dates or at different prices and sells or transfers some (but not all) of the shares of that stock, and the lot from which the stock is sold or transferred is not adequately identified, the shares deemed sold are the earliest acquired shares (the "first-in-first-out rule").[96] If a taxpayer makes an adequate identification ("specific identification") of shares of stock that it sells, the shares of stock treated as sold are the shares that have been identified.[97] A taxpayer who owns shares in a regulated investment company ("RIC") generally is permitted to elect, in lieu of the specific identification or first-in-first-out methods, to determine the basis of RIC shares sold under one of two average-cost-basis methods described in Treasury regulations (together, the "average basis method").[98]

In the case of the sale, exchange, or other disposition of a specified security (defined below) to which the basis reporting requirement described below applies, the first-in-first-out rule, specific identification, and average basis method conventions are applied on an account by account basis.[99] To facilitate the determination of the cost of RIC stock under the average basis method, RIC stock acquired before January 1, 2012 generally is treated as a separate account from RIC stock acquired on or after that date unless the RIC (or a broker holding the stock as a nominee) elects otherwise with respect to one or more of its stockholders, in which case all the RIC stock with respect to which the election is made is treated as a single account and the basis reporting requirement described below applies to all of that stock.[100]

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[94] Sec. 1001.

[95] Sec. 1016.

[96] Treas. Reg. sec. 1.1012-1(c)(1).

[97] Treas. Reg. sec. 1.1012-1(c).

[98] Treas. Reg. sec. 1.1012-1(e).

[99] Sec. 1012(c)(1).

[100] Sec. 1012(c)(2).

The basis of stock acquired after December 31, 2010 in connection with a dividend reinvestment plan ("DRP") is determined under the average basis method for as long as the stock is held as part of that plan.[101]

Basis reporting

A broker is required to report to the IRS a customer's adjusted basis in a covered security that the customer has sold and whether any gain or loss from the sale is long-term or short-term.[102]

A covered security is, in general, any specified security acquired after an applicable date specified in the basis reporting rules. A specified security is any share of stock of a corporation (including stock of a RIC); any note, bond, debenture, or other evidence of indebtedness; any commodity, or contract or derivative with respect to such commodity, if the Treasury Secretary determines that adjusted basis reporting is appropriate; and any other financial instrument with respect to which the Treasury Secretary determines that adjusted basis reporting is appropriate.

For purposes of satisfying the basis reporting requirements, a broker must determine a customer's adjusted basis in accordance with rules intended to ensure that the broker's reported adjusted basis numbers are the same numbers that customers must use in filing their tax returns.[103]

Explanation of Provision

The provision requires that the cost of any specified security sold, exchanged, or otherwise disposed of on or after January 1, 2014 be determined in accordance with the average basis method now permitted for RIC stock.

To facilitate the determination of the cost of a specified security in accordance with the average basis method, the provision treats any specified security that is acquired before January 1, 2014 as in a separate account from any security that that is acquired on or after that date. Accordingly, a taxpayer determines the basis of any specified security acquired in 2014 and later by disregarding the basis of specified securities acquired before 2014.

As under present law, basis is determined on an account-by-account basis, so that if a taxpayer owns specified securities in more than one account, basis computations are made separately for securities in each account.

In the event the Treasury Secretary expands the basis reporting requirements so that they apply to additional classes of securities acquired no earlier than an effective date that is after

[101] Sec. 1012(d)(1). Other special rules apply to DRP stock. See sec. 1012(d)(2) and (3).

[102] Sec. 6045(g) and Treas. Reg. sec. 1.6045-1(d).

[103] See sec. 6045(g)(2).

January 1, 2014, the provision's average basis and separate account rules apply only to sales or other dispositions of those securities on or after that later effective date.

The provision requires that brokers use the average basis method in satisfying their basis reporting requirements.

Because the provision requires an average basis method for sales of all stock, the special present law rules for DRP stock are repealed.

Effective Date

The provision applies to sales, exchanges, and other dispositions after December 31, 2013.

8. Wash sales by related parties (sec. 422 of the discussion draft and sec. 1091 of the Code)

Present Law

A taxpayer may not deduct losses from the disposition of stock or securities if substantially identical stock or securities (or an option to acquire such property) are acquired by the taxpayer during the period beginning 30 days before the date of sale and ending 30 days after such date of sale (a "wash sale").[104] Commodity futures are not treated as stock or securities for purposes of this rule. A deduction is allowed if the taxpayer incurred the loss in the ordinary course of business as a dealer in stock or securities.

If a loss is disallowed because of the wash sale rules, the basis of the substantially identical stock or securities is adjusted to include the disallowed loss. The holding period for substantially identical stock or securities acquired in a wash sale includes the holding period of the stock or securities sold.

Similar rules apply to disallow any loss realized on the closing of a short sale of stock or securities if substantially identical stock or securities are sold (or a short sale, option or contract to sell is entered into) during the applicable period before and after the closing of the short sale.

Under IRS guidance, transactions with certain related parties may also constitute wash sales. If a taxpayer sells stock and the taxpayer's spouse or a corporation controlled by the taxpayer buys substantially identical stock, the transaction constitutes a wash sale.[105] If an individual sells stock or securities for a loss and acquires substantially identical stock or securities within an individual retirement account or a Roth IRA within the specified period of

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[104] Sec. 1091.

[105] Internal Revenue Service, *Investment Income and Expenses (Including Capital Gains and Losses),* Publication 550, October 16, 2012, p. 59.

time, the loss on the sale of the stock or securities is disallowed under the wash sale rules, and the individual's basis in the IRA or Roth IRA is not increased.[106]

Explanation of Provision

The provision expands application of the wash sale rules to acquisition of substantially identical stock or securities by the taxpayer or a related party. Furthermore, the basis of the substantially identical stock or securities is not adjusted to include the disallowed loss in the case of any acquisition by a related party other than the taxpayer's spouse.

For purposes of the wash sale rules, a related party means: (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 individual retirement arrangement ("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.

Most relationships are determined as of the time of the acquisition of substantially identical stock or securities. Spousal and dependency relationships are determined for the taxable year that includes such acquisition. Marital status is determined under section 7703, except that a husband and wife who file separate returns for any taxable year and live apart at all times during such taxable year shall not be treated as married individuals for purposes of the wash sale rules.

Regulatory authority is provided to prevent the avoidance of the purposes of the subsection dealing with related parties, including regulations that treat persons as related parties if such persons are formed or availed of to avoid the purposes of such subsection.

Effective Date

The provision applies to sales and other dispositions after December 31, 2013.

[106] Rev. Rul. 2008-5.