



Overview of Ways and Means Tax Reform Discussion Draft: Financial Products

Background. A contributing factor to the 2008 financial crisis was the ability to hide and disguise potentially significant risks through Wall Street’s use of derivatives and other novel financial products. The rapid growth and abuse of these derivatives contributed to an environment that led to the seizure of our financial system, from which the U.S. economy still has not fully recovered. At the same time, arcane and often inconsistent tax rules governing derivatives and other financial products have fostered tax-shelter opportunities for some investors while imposing prohibitive tax burdens on taxpayers trying to maintain or sell distressed assets – a process necessary to economic recovery.

A December 6, 2011 joint hearing with the Senate Finance Committee, one of the 20 hearings the Ways and Means Committee (“the Committee”) held during the 112th Congress on comprehensive tax reform, examined the tax treatment of financial products. Based on testimony received during this hearing and input from tax practitioners, experts and commentators such as the American Bar Association Tax Section, the Committee is releasing a discussion draft of proposals to reform the tax treatment of financial products.

While the discussion draft updates antiquated tax rules that have not kept pace with innovation in the financial-products market, it also makes significant changes to the way the United States taxes financial products. In the interest of transparency, the Committee is soliciting feedback from a broad range of stakeholders, practitioners, economists, and members of the general public on how to improve this proposed set of reforms. This discussion draft follows the October 26, 2011 release of a discussion draft on international tax reform. Like that previous discussion draft, this discussion draft will be considered as part of comprehensive tax reform legislation that broadens the base, lowers rates, and moves the United States to a more economically competitive tax system on a revenue-neutral basis.

Summary of Financial Products Discussion Draft. The discussion draft includes several reforms that would update and rationalize the tax treatment of financial products. Specifically, the discussion draft includes the following proposals:

- **Provide Uniform Tax Treatment of Financial Derivatives.** The draft would require taxpayers engaged in speculative financial activity—*but not business hedging against common risks*—to mark certain financial derivative products to fair market value at the end of each tax year, thus triggering the recognition of gain or loss for tax purposes. The tax code already requires or permits mark-to-

market accounting for specific financial products, such as certain contracts and options that are traded on exchanges, and for specific taxpayers, such as securities and commodities dealers and traders.

Broadly extending mark-to-market accounting treatment to derivatives would provide a more accurate and consistent method of taxing these financial products and make them less susceptible to abuse, without affecting most small investors who normally do not invest in these products. Derivatives that are used by businesses in the ordinary course of their businesses to hedge against price, currency, interest rate, and other risks would *not* be affected.

- **Simplify Business Hedging Tax Rules.** For taxpayers that are engaged in hedging business risks, the draft would allow transactions that are properly treated as hedges for financial accounting purposes to be treated as hedges for tax purposes. This taxpayer-favorable proposal would minimize inadvertent failures to identify a transaction as a hedge for tax purposes, even though the transaction satisfies all of the substantive requirements for hedging transaction tax treatment.
- **Eliminate “Phantom” Tax Resulting from Debt Restructurings.** The draft would reform the tax rules that apply to debt restructurings that do not involve a forgiveness of principal. This change would reduce the prevalence of “phantom” cancellation-of-indebtedness income when debt is restructured—a common practice during economic downturns—thereby creating a more taxpayer-favorable rule.
- **Harmonize the Tax Treatment of Bonds Traded at a Discount or Premium on the Secondary Market.** For bonds that are acquired on a secondary market at a discount, the draft would require the holder of the bond to recognize taxable income on the discount over the remaining life of the bond—conforming the tax treatment of such transactions to bonds acquired at a discount directly from the borrower. At the same time, the amount of discount to be recognized for tax purposes would be limited to the discount that typically reflects an increase in interest rates that has occurred since the date the bond was originally issued—as opposed to steeper discounts that often reflect deterioration in the creditworthiness of the borrower. The draft also would allow taxpayers to claim “above-the-line” deductions for bonds acquired at a premium on a secondary market.
- **Increase the Accuracy of Determining Gains and Losses on Sales of Securities.** To simplify tax compliance and administration, and to determine more accurately the amount of gain or loss when a security is sold, the draft would require the cost basis of the security to be based on the average cost basis of all other shares or units of the identical security held by the taxpayer.
- **Prevent the Harvesting of Tax Losses on Securities.** The so-called “wash sale” anti-abuse rule has been a feature of the tax code for decades. It is intended to

prevent taxpayers from harvesting tax losses by selling securities at a loss and then immediately reacquiring the same securities. However, 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. The draft would reform the wash sale rule so that it applies to transactions involving closely related parties.

Unaddressed Issues. The Committee recognizes that the discussion draft does not address several technical and policy issues that may need to be resolved in final legislation. The Committee invites comments on how to address such issues, in particular those related to:

- Valuing derivatives that would become subject to mark-to-market tax treatment.
- Identifying financial products tax provisions under current law that may become obsolete or may require modification in light of the discussion draft.
- Information reporting rules that may be necessary to implement the discussion draft, including the reporting rules that are contained in the draft.
- Other areas of financial products taxation that are not addressed in the discussion draft.