Mark-to-Market Possible; IRS Halts Financial-Products Plans

By Allyson Versprille

The IRS has put some financial-product projects on hold in anticipation of a tax code revamp that could include discussion of a mark-to-market regime for derivatives, an agency official said.

The Internal Revenue Service has been “triaging” items in its Priority Guidance Plan “and spending time on the business plan projects that are most likely to remain relevant if there is a much broader mark-to-market regime enacted by Congress,” said Helen M. Hubbard, associate chief counsel of the IRS's Financial Institutions and Products Division in the Office of Chief Counsel. This strategy helps the IRS make the best use of its “scarce resources,” she said Jan. 17 at a Practising Law Institute seminar on the taxation of financial products.

Projects that have been placed on hold include final regulations under tax code Section 446 related to the timing and character of payments, including contingent payments, made pursuant to notional principal contracts. The IRS published proposed regulations in 2004, and temporary and proposed regulations in 2015.

Regulations under Section 1001 on the modification of nondebt financial instruments are also being put on the back burner until it is clear whether Congress will enact a new mark-to-market regime. Section 1001 governs the amount of gain or loss resulting from the sale of property.

Jason G. Kurth, an attorney in the IRS's Office of Associate Chief Counsel (Financial Institutions & Products), said a mark-to-market regime will “influence and affect the scope of whatever guidance we end up releasing if any” under Section 1001. Agency officials are starting to consider whether Section 1001 events matter at all under such a regime, said Kurth, who is assigned to the project.

Existing and Prior Legislation

President Barack Obama's administration has pushed the mark-to-market idea, as has Senate Finance Committee ranking member Ron Wyden (D-Ore.). His draft legislation—the Modernization of Derivatives Tax Act—would treat derivatives as if they had been sold and repurchased at the end of each year, require ordinary tax treatment of resulting gains and losses and establish a source based on a taxpayer's country of residence.

Wyden's plan would apply to all derivatives, not just those that are publicly traded or that reference publicly traded assets or indices. His proposal adopts some ideas included in a discussion draft released in 2013 by former Ways and Means Committee Chairman Dave Camp (R-Mich.).

Viva Hammer, legislation counsel at the Joint Committee on Taxation, said both the Camp and Wyden drafts attempt to offer a substantially better system for taxing derivatives than what exists today.

“This is an area in disarray,” she said. “There's a lot of opportunity for taking advantage of it” and there are people who are profiting from that disorder, she said. That being said, Wyden's draft isn't perfect, she said. “It can't be perfect.”

Practitioners have expressed concern with the act's “investment hedging unit regime,” which Hammer described as an attempt to establish one set of rules to replace the existing straddle and constructive sale rules—both anti-abuse measures.

Michael S. Farber, a partner in Davis Polk & Wardwell LLP's Tax Department, however, pointed out a situation where the straddle rules would still apply, creating a complex tax problem under the Wyden plan. Hammer agreed that the straddle rules would need to be amended to make the senator's mark-to-market proposal work.

Financial Products, House Blueprint

Erika W. Nijenhuis, a partner at Cleary Gottlieb Steen & Hamilton LLP, said the House GOP's tax blueprint, released last summer, may also have broad implications for financial products.

Specifically, the plan's denial of a deduction for net business interest expense may have repercussions within the financial services sector, she said.

“If you think about a highly leveraged company, which is where that would obviously bite to the greatest extent, that would have the affect of shifting the desirability of debt versus equity,” Nijenhuis said. Equity in this sense means a security like nonqualified preferred stock, which “kind of looks, feels and smells like debt but isn't debt for tax purposes,” she said.

Such stock may become more desirable because if a highly leveraged company is looking “shaky,” it's possible that in the future it will degrade or fail, she said. If the company fails, it might avoid cancellation of debt “income if it has to restructure the instrument, and its investors might not have to worry about market discount” by shifting from debt to equity under the new tax system.

This diverges from the traditional scenario in which taxpayers argue in favor of debt and the government argues against it, Nijenhuis said.

Border Adjustment

The House's border adjustment proposal, which would tax imports and exempt exports, may also impact financial products, Nijenhuis said.

“People who are thinking about how that border-adjusted regime might affect financial institutions and financial products—in particular financial products—have observed that in VAT regimes around the world, financial products are typically exempt from the regime because it just doesn't make sense, the concepts don't make sense,” she said. VAT stands for “value-added tax” and is a form of consumption tax often used by countries in the European Union.

“If we wound up with something similar, or if we had something that was focused, for example, on transactions undertaken by financial institutions, there would be a lot of questions about what is a financial product and what is a financial institution,” Nijenhuis said.

Additionally, economists consider a “massive shift in the value of the dollar” to be an essential component of a border-adjusted regime, she said. They estimate “a rise in the value of the dollar by about 25 percent in order to adjust for the differences in the attractiveness of imports and exports,” she said.

“And if that were to happen, you could imagine a very wide range” of issues arising in relation to financial products, Nijenhuis said.