

Straddle Rules Need Amending in Face of Derivatives Bill




POSTED ON JAN. 23, 2017

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If Congress passes draft legislation that would apply mark-to-market tax treatment to derivatives, current straddle rules would need to be revisited, Viva Hammer, Joint Committee on Taxation legislation counsel, said January 17.

The straddle rules would have to be amended for the Modernization of Derivatives Tax Act (MODA) discussion draft  to be usable, Hammer said at a conference sponsored by the Practising Law Institute in New York. Hammer acknowledged that there would be border-crossing problems that would need to be worked out if MODA  were to be enacted. "We want to make it as good as possible, knowing that we are never going to get it just right," she added. (Prior analysis: *Tax Notes*, June 6, 2016, p. 1301 .)

Released last year by Senate Finance Committee ranking minority member Ron Wyden, D-Ore., MODA simplifies derivatives taxation by requiring mark-to-market and ordinary income tax treatment. Under MODA, residence of the recipient controls source and gain or loss is calculated under ordinary tax principles after termination, sale, or transfer.

MODA creates a rule for investment hedging units (IHUs) for derivatives that have a delta of -0.7 or less in comparison with their underlying investments. Delta is the ratio of expected change in the fair market value of the derivative to any change in the FMV of the investment. Taxpayers must test for delta when an IHU is established and later modified, and derivative contracts and associated investments will be marked to market and taxed as ordinary income while the IHU exists. Taxpayers may make an irrevocable election to forgo the delta test and treat all derivatives concerning an underlying investment as part of an IHU. Taxpayers who fail to properly identify IHUs are treated as making the election.


Hammer explained that the intent of the law was to have all gain or loss in an IHU as ordinary and that on entrance into the regime, the character of income would not be converted to ordinary, but would be preserved.


Michael Farber of Davis Polk & Wardwell LLP cited the problem between the interplay of MODA and the straddle rules -- the latter of which would survive the proposed change -- as the biggest hurdle facing the potential regime. The obstacle presented itself when a taxpayer entered into offsetting positions that did not reach a delta level of -0.7, but still were correlated enough to be within the straddle rules so that a mixed straddle position was established.

"You will have an even worse set of rules because . . . you will be marking only the derivative and only its gains

and only as ordinary income because losses can't be recognized to the extent of unrecognized gains in offsetting positions under the straddle rules," Farber said. Unless the regime is fixed, taxpayers should make the election in order to avoid this "uneconomic" consequence, he added.

Hammer noted that in drafting MODA, [sections 1256](#) and [475](#), which treat derivatives as if they were assets, were "extremely primitive" and did not present adequate models for the treatment of derivatives. Although the law for this area is in disarray, there was bipartisan agreement that derivative taxation needed changing, she added.

"We have both sides of the aisle and both sides of Congress that have expressed very similar views on the taxation of derivatives," Hammer said. "When people say to me, 'This is unrealistic,' I always say, 'Never say that Congress will never do something.' Once language has come out, there is always somebody who might need it or might be interested in making it law, as we know from the partnership audit rules that nobody expected and were suddenly law." (Related coverage: [p. 406](#) .

Hammer's remarks about potential passage need not be evaluated in a vacuum. At a separate conference panel the same day, an IRS official said the agency is reassessing its planned guidance projects in anticipation of MODA's possible enactment. (Related coverage: [p. 404](#) .

DOCUMENT ATTRIBUTES

CODE SECTIONS	SECTION 475 -- MARK-TO-MARKET ACCOUNTING
MAGAZINE CITATION	TAX NOTES, JAN. 23, 2017, P. 405 154 TAX NOTES 405 (JAN. 23, 2017)
TAX ANALYSTS DOCUMENT NUMBER	DOC 2017-803