

**TECHNICAL EXPLANATION OF THE
“MODERNIZATION OF DERIVATIVES TAX ACT OF 2021”**

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of the
JOINT COMMITTEE ON TAXATION



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INTRODUCTION

On August 5, 2021, Senate Committee on Finance Chairman Ron Wyden introduced the “Modernization of Derivatives Tax Act of 2021” (“MODA”). This document,¹ prepared by the staff of the Joint Committee on Taxation, provides background, a description of present law, and a description of the bill.

¹ This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the “Modernization of Derivatives Tax Act of 2021”* (JCX-34-21), August 5, 2021. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

BACKGROUND²

A derivative is a contract in which the amount of at least one contractual payment is calculated by reference to a change in the value, level, or status of something (or a combination of things). The thing whose value, level, or status determines the amount of any such payment, and thereby determines the derivative's value, is called the "underlying." Examples of underlyings that are referred to by derivatives include assets, liabilities, indices, and events. The most common types of derivatives are options, forwards, futures, and swaps.

The Federal income tax laws governing taxation of derivatives were developed piecemeal and without a consistent underlying policy, giving rise to complexity and inconsistency. Timing and character rules with respect to various derivatives may differ depending on the type of taxpayer entering into the derivative (*e.g.*, a dealer in securities),³ the use of the derivative (*e.g.*, as a hedge),⁴ the type of underlying (*e.g.*, a foreign currency), how the derivative is traded (*e.g.*, on a U.S. exchange), or the application of other overriding rules (*e.g.*, the straddle rules).⁵ Further, derivatives or combinations of derivatives that are similar economically may be subject to different tax rules.

PRESENT LAW

In general

The following describes the features of the most common derivatives and the applicable timing, character, and source rules under current law.⁶ In addition, there is discussion of special rules for certain kinds of taxpayers and certain combinations of financial positions, as well as of certain other relevant aspects of Federal income tax law.

² This document provides a description of the Modernization of Derivatives Tax Act of 2021 ("MODA"), a bill to amend the Internal Revenue Code of 1986, as amended (the "Code"), to modernize the tax treatment of derivatives and their underlying investments, and for other purposes.

³ Sec. 475. Unless otherwise stated, all section references are to the Code.

⁴ Sec. 1221(a)(7).

⁵ Sec. 1092.

⁶ For additional Congressional discussion of the issues discussed herein, see Select Revenue Measures Subcommittee of House Committee on Ways and Means Hearing on "Ways and Means Financial Products Tax Reform Discussion Draft," January 24, 2013, available at <https://waysandmeans.house.gov/legislation/hearings/select-revenue-measures-subcommittee-hearing-ways-and-means-financial-products>. For additional reading regarding the issues discussed herein, see, *e.g.*, American Bar Association Section of Taxation, "Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code," 2011; Eric Toder and Alan D. Viard, "Replacing Corporate Tax Revenues with a Mark-To-Market Tax on Shareholder Income," *National Tax Journal*, Vol. 69(3), 2016; Alex Raskolnikov, "Taxation of Financial Products: Options for Fundamental Reform," *Tax Notes*, Vol. 133, 2011, p. 1549; Reed Shuldiner, "A General Approach to the Taxation of Financial Instruments," *Texas Law Review*, Vol. 71, 1992, p. 243; David A. Weisbach, "Tax Responses to Financial Contract Innovation," *Tax Law Review*, Vol. 50, 1995, p. 491; Alvin C. Warren, Jr., "Financial Contract Innovation and Income Tax Policy," *Harvard Law Review*, Vol. 107, 1993, p. 460.

Options

Features

An option is a derivative in which one party purchases the right to buy an underlying from, or to sell an underlying to, another party on a fixed date or during a fixed period of time in exchange for a future payment whose value is fixed when the contract is entered into.⁷ A common underlying for an option is corporate stock. The purchaser of the option is also called the option holder; the seller of the option is also called the option writer or option issuer. When the option holder makes the payment to the other party and receives the underlying (or conversely transfers the underlying to the other party and receives the payment), the option holder is said to exercise its right. The latest time the option holder can exercise its right is called the expiration date. The initial payment by the option holder is called the premium; the payment made for the underlying (whether at expiration or otherwise) is called the strike price. A European-style option is an option that can be exercised only on the expiration date. An American-style option is an option that can be exercised at any time on or before the expiration date.

A call option is an option in which the option holder has the right to buy the underlying. A put option is an option in which the option holder has the right to sell the underlying. An option is physically settled when ownership of the underlying is delivered from one party to the other. An option is cash settled when, instead of delivering the underlying upon exercise, the option seller pays cash equal to the difference between the strike price and the value of the underlying at the expiration date.

Timing

In general, there are no tax consequences to the purchaser or seller upon entering into an option contract, even though option premiums are paid without any possibility for recovery or return. The option holder does not deduct the premium and the option seller does not include the premium in income.⁸ Instead, the amount of gain or loss is determined at the time of a subsequent recognition event (*e.g.*, when the option is exercised or sold). When a holder exercises a call option and buys the underlying, the basis in the property acquired reflects both the strike price and the premium. When a holder exercises a put option and sells the underlying, the amount of the premium reduces the amount received in the sale.

Character and source

For an option purchaser, gain or loss attributable to either (1) the sale or exchange of the option or (2) the loss from failure to exercise the option is considered gain or loss from property

⁷ This discussion does not address options granted in connection with the performance of services.

⁸ Rev. Rul. 78-182, 1978-1 C.B. 265. Courts decided receipt of option premiums were nontaxable because they could not determine whether the premiums were gain or return of capital until the option expired. *Virginia Iron Coal & Coke Co. v. Commissioner*, 37 B.T.A. 195 (1938), *aff'd*, 99 F.2d 919 (4th Cir. 1938).

of the same character as the option's underlying.⁹ If an option purchaser exercises a cash-settled option, then gain or loss is short-term or long-term depending on whether the option purchaser has held the option for more than one year.¹⁰ If an option purchaser exercises a physically settled option, the holding period for the property acquired is calculated from the date the option is exercised.¹¹ Option purchasers may be treated differently depending on whether they hold cash-settled or physically settled options, even though their economic positions may be similar.¹²

An option seller has ordinary income if the option is not exercised,¹³ but if the option is with respect to stocks, securities, commodities, and commodity futures, any gain or loss from closing or lapse is short-term capital gain or loss.¹⁴

An option generally is treated as personal property. Income from the sale of personal property generally is sourced to the residence of the seller.¹⁵ Specific authority is provided for the Secretary¹⁶ to write regulations for sourcing of income from trading in futures contracts, forward contracts, options contracts, and other instruments;¹⁷ Treasury, however, has not exercised this authority. Thus, in general, the default sourcing rules should apply. That is, gain or loss with respect to an option for a U.S. person is U.S. source gain or loss and for a foreign person is foreign source gain or loss. For that reason, in general, a foreign person is not subject to U.S. withholding tax on income with respect to an option.

⁹ Sec. 1234(a)(1).

¹⁰ Rev. Rul. 88-31, 1988-1 C.B. 302.

¹¹ *Ibid.* The new holding period begins on the day the option is exercised if the underlying is stock or other securities acquired from the corporation that issued the securities. Sec. 1223(5). Otherwise, the holding period begins the day after the option is exercised. *Weir v. Commissioner*, 10 T.C. 996 (1948), aff'd, 173 F.2d 222 (3d Cir. 1949).

¹² Consider two identical options, one cash-settled and the other physically settled. If both are held more than a year, then upon exercise the holder of the cash-settled option may have long-term capital gain while the holder of the physically settled option will have stock (held at a gain). Because the holding period of the stock starts only after exercise, however, if the stock is sold the next day, the holder will have short-term capital gain. The results would be different if the option purchaser were using the option as a hedge, a dealer in securities, or a corporation with an option on its own stock.

¹³ Treas. Reg. sec. 1.1234-1(b).

¹⁴ Sec. 1234(b).

¹⁵ Sec. 865(a). Other rules override this residence-based source rule for certain kinds of gains, such as income from the sale of inventory property. See, e.g., sec. 865(b).

¹⁶ Unless otherwise noted, all references to the "Secretary" are to the Secretary of the Treasury.

¹⁷ Sec. 865(j)(2).

Forwards

Features

A forward is a derivative in which one party agrees to deliver an underlying to another party on a fixed date for a fixed price. A common underlying for a forward is a commodity. The party agreeing to deliver the underlying is called the short party; the party agreeing to pay is called the long party. The date on which the short party must deliver is called the delivery or expiration date. The payment by the long party at delivery is called the forward price. For most forwards, no payment is made when the contract is signed. In a prepaid forward, the long party pays the short party the forward price (discounted to present value on the payment date) at the time the parties enter into the contract.¹⁸ A variable forward requires the short party to deliver an amount of property that varies according to a formula agreed to when the contract is signed.¹⁹ A combination of a European-style put option and a European-style call option with respect to the same underlying property with the same strike price and the same expiration date exactly replicates the characteristics of a forward on the underlying property. This is known as put-call parity.

A forward is physically settled if ownership of the underlying is delivered from one party to the other. A forward is cash settled if, rather than delivering the underlying on the delivery date, one party pays cash equal to the difference between the forward price and the value of the underlying on the delivery date.

The terms “forward” and “futures contract” have precise definitions in the Federal income tax law, and those definitions do not always coincide with how the terms are used for regulatory purposes or in common parlance. Under Federal income tax law, a futures contract is a forward that is traded on a regulated U.S. exchange.²⁰

Timing

In general, there are no tax consequences to the long party or the short party upon entering into a forward.²¹ If a forward is physically settled, the short party recognizes gain or loss in an amount equal to the difference between the forward price and the short party’s basis in the underlying on the delivery date.²² The long party takes a basis in the underlying equal to the

¹⁸ See Notice 2008-2, 2008-1 C.B. 252.

¹⁹ See, e.g., *Anschutz Co. v. Commissioner*, 135 T.C. 78 (2010), aff’d, 664 F.3d 313 (10th Cir. 2011).

²⁰ The tax treatment of futures contracts is discussed below under the heading “Section 1256 contracts.”

²¹ If, however, the forward buyer obtains possession of the underlying property prior to the delivery date specified in the contract, the transaction may be considered “closed” for tax purposes, and the transfer of possession may be treated as a realization event. See, e.g., *Commissioner v. Union P. R. Co.*, 86 F.2d 637 (2d Cir. 1936) and *Merrill v. Commissioner*, 40 T.C. 66 (1963).

²² Sec. 1001.

forward price; any gain or loss (as a result of a difference between the forward price and the value of the underlying on the delivery date) is deferred until a subsequent realization event.

Character and source

In general, the character of the gain or loss with respect to a forward is the same as the character of the property delivered.²³ Gain or loss on the sale or exchange of a forward is long-term capital gain or loss if the contract has been held for longer than the requisite holding period.²⁴ Cash settlement of a forward is treated as a sale or exchange.²⁵

A forward, like an option, generally is treated as personal property. Income from the sale of personal property generally is sourced to the residence of the seller.²⁶ Thus, in general, the default sourcing rules should apply. That is, gain or loss with respect to a forward for a U.S. person is U.S. source gain or loss and for a foreign person is foreign source gain or loss. For that reason, in general, a foreign person is not subject to U.S. withholding tax on income with respect to a forward.

If a forward qualifies as a commodity futures contract not subject to section 1256, the long party's holding period with respect to the underlying includes the period during which the party held the forward.²⁷ For other physically settled forwards, the holding period of the underlying begins when the benefits and burdens of ownership are transferred from the short party to the long party.²⁸ With respect to short parties to physically settled securities forwards and commodities futures, section 1233 and the accompanying regulations provide rules regarding

²³ Sec. 1234A and Prop. Treas. Reg. sec. 1.1234A-1(c)(1).

²⁴ *Carborundum Co. v. Commissioner*, 74 T.C. 730, 733-42 (1980); *American Home Products Corp. v. United States*, 220 Ct. Cl. 369, 383-87 (Ct. Cl. 1979); *Hoover Co. v. Commissioner*, 72 T.C. 206, 250 (1979).

²⁵ *Estate of Israel v. Commissioner*, 108 T.C. 208, 217 (1997).

²⁶ Sec. 865(a). Other rules override this residence-based source rule for certain kinds of gains, such as income from the sale of inventory property. See, e.g., sec. 865(b). Again, specific authority is provided for the Secretary (under section 865(j)(2)) to write regulations for sourcing of income from trading in futures contracts, forward contracts, options contracts, and other instruments; Treasury, however, has not exercised this authority.

²⁷ Sec. 1223(7); see also Treas. Reg. sec. 1.1223-1(h). If the contract is physically settled and section 1256 applies, the taxpayer's holding period begins on the delivery date and does not include the prior period during which the taxpayer held the forward contract. Sec. 1256(c).

²⁸ Rev. Rul. 69-93, 1969-1 C.B. 139. In a case involving a physically settled forward for the sale of convertible debentures, one court held that the long party's holding period with respect to the debentures did not begin until delivery of the underlying debentures where: (1) the short party continued to receive interest payments on the debentures while the forward was open; (2) the short party was free to sell the debentures while the contract was open (provided that the short party delivered substantially identical property on the delivery date); and (3) the short party was free to use the debentures as security for other financial transactions. *Stanley v. United States*, 436 F. Supp. 581, 583 (N.D. Miss. 1977).

holding periods,²⁹ although these rules have been partly supplanted by section 1234B (governing certain securities futures contracts) and section 1256 (governing regulated commodities futures contracts). For transactions to which section 1233 applies, a short party that physically delivers property to close a contract recognizes capital gain or loss on the transaction as short term or long term depending on the period for which the short party holds the property prior to delivery.³⁰

Forwards relating to the sale of a single security or a narrow-based security index³¹ are subject to a separate regime under section 1234B. The character of gain or loss with respect to the sale or exchange of a securities futures contract is the same as the character of the gain or loss would be with respect to the sale or exchange of the underlying. Section 1234B also provides that capital gain or loss on a securities futures contract is treated as short-term capital gain or loss, regardless of the taxpayer's holding period.

Swaps and notional principal contracts

Features

Under Federal income tax law, the term “notional principal contract” roughly corresponds to what is colloquially known as a “swap.” However, the term as defined in the Code covers a narrower range of contracts than the colloquial term.³² Treasury regulations define a notional principal contract 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.³³ A specified index is defined as a fixed rate, price, or amount that must be

²⁹ Although section 1233 only refers to “short sales,” the accompanying regulations indicate that section 1233 applies to forward contracts as well. See Treas. Reg. sec. 1.1233-1(c)(6) (example 6); see also *Hoover Co. v. Commissioner*, 72 T.C. 206, 249 (1979) (applying section 1233 to certain forward contracts).

³⁰ Sec. 1233.

³¹ The term “narrow-based security index” includes indices with nine or fewer component securities, indices that are heavily weighted toward a small number of component securities, or indices weighted toward securities with low trading volumes. 15 U.S.C. sec. 78c(a)(55). An option on a broad-based security index is treated as a nonequity option and is subject to section 1256.

³² A bullet swap—a swap with payment only at the maturity of the contract—is included within the colloquial use of the term “swap.” Whether it constitutes a notional principal contract under current law is uncertain. For a discussion of bullet swaps, see Joint Committee on Taxation, *Present Law and Issues Related to the Taxation of Financial Instruments and Products* (JCX-56-11), December 2, 2011, fn. 134.

³³ Treas. Reg. sec. 1.446-3(c)(1)(i). Proposed regulations revise the definition of notional principal contract as follows: “A notional principal contract is a financial instrument that requires one party to make two or more payments to the counterparty 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.” Prop. Treas. Reg. sec. 1.446-3(c)(1)(i). A definition of payment is provided in these proposed regulations that has no parallel in the existing Treasury regulations. “[A] payment includes an amount that is fixed on one date and paid or otherwise taken into account on a later date.” Prop. Treas. Reg. sec. 1.446-3(c)(1)(ii). The bullet swap described in the

based on objective financial information not in control of either party.³⁴ 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 or obligations under the contract but is not borrowed or loaned between the parties.³⁵

Examples of notional principal contracts include interest rate swaps, currency swaps, and equity swaps.³⁶ Treasury regulations exclude certain instruments from the definition of notional principal contract, including section 1256 contracts, futures contracts, forwards, options, and instruments or contracts that constitute indebtedness for Federal tax purposes.

Timing

For purposes of calculating the inclusion of income or expense flowing from a notional principal contract, the regulations divide payments exchanged by the parties to the notional principal contract into three categories: (1) periodic payments (made at least annually); (2) termination payments (made at the end of the contract's life); and (3) nonperiodic payments (all other payments).³⁷ Taxpayers must recognize periodic and nonperiodic payments using a specified accrual method for the taxable year to which the payment relates and must recognize a termination payment in the year the notional principal contract is extinguished, assigned, or terminated.³⁸ A swap with a nonperiodic payment is treated as two transactions: an on-market level payment swap and a loan.³⁹ The loan must be accounted for independently of the swap. Treasury regulations proposed in 2004 (the "2004 proposed regulations") provide that contingent nonperiodic payments (such as a single payment at termination tied to the change in value of the underlying) are accrued over the life of the swap based on an estimate of the amount of the

footnote immediately above might come within the definition of notional principal contract under the proposed regulations.

³⁴ Treas. Reg. sec. 1.446-3(c)(2) and (4).

³⁵ Treas. Reg. sec. 1.446-3(c)(3).

³⁶ *Ibid.*

³⁷ Treas. Reg. sec. 1.446-3(e), (f), and (h).

³⁸ *Ibid.*

³⁹ Treas. Reg. sec. 1.446-3T(g)(4). Temporary and proposed regulations provide that the loan component that is in a nonperiodic payment is to be taxed as a loan regardless of its size. This is a change from prior law in which the loan was only treated as such if it were "significant." There are two exceptions under temporary Treasury regulations: (1) a nonperiodic payment made under a notional principal contract with a term of one year or less; and (2) notional principal contracts with nonperiodic payments subject to certain margin or collateral requirements.

payment.⁴⁰ The amount of a taxpayer's accrual is redetermined periodically as more information becomes available.⁴¹

Character and source

Final Treasury regulations do not address the character of notional principal contract payments. However, the regulations proposed in 2004 under section 1234A provide that any periodic or nonperiodic payment generally constitutes ordinary income or expense.⁴² The preamble to the 2004 proposed regulations explains that ordinary income treatment is appropriate because neither periodic nor nonperiodic payments results from the sale or other disposition of a capital asset. The 2004 proposed regulations provide that gain or loss attributable to the termination of a notional principal contract is capital if the contract is a capital asset to the taxpayer. The proposed regulations, however, do not specify whether a taxpayer who holds a notional principal contract for more than one year should recognize capital gain or loss on account of a termination payment as short term or long term. The proposed regulations do provide that final settlement payments with respect to a notional principal contract are not termination payments under section 1234A.⁴³

A swap generally is treated as personal property. Income from the sale of personal property generally is sourced to the residence of the seller.⁴⁴ Thus, in general, the default sourcing rules apply. That is, gain or loss with respect to a swap for a U.S. person is U.S. source gain or loss and for a foreign person is foreign source gain or loss. Special rules for dividend equivalent payments under section 871(m), however, treat certain derivative payments as U.S. source. Thus, except where section 871(m) applies, a foreign person generally is not subject to U.S. withholding tax on swap income.

Securities and commodities dealers and traders

Special tax rules apply to dealers and traders in securities and commodities.

Dealers in the financial industry are of two types: those that hold inventory and those that do not. Dealers that hold inventory make their profit from the difference between the price at which they buy their inventory and the price at which they sell it; the difference is called a

⁴⁰ Notional Principal Contracts; Contingent Nonperiodic Payments: Notice of Proposed Rulemaking, *Fed. Reg.* vol. 69, 38, February 26, 2004, p. 8886.

⁴¹ *Ibid.*

⁴² Prop. Treas. Reg. sec. 1.1234A-1.

⁴³ Prop. Treas. Reg. sec. 1.1234A-1(b).

⁴⁴ Sec. 865(a). Other rules override this residence-based source rule for certain kinds of gains, such as income from the sale of inventory property. See, e.g., sec. 865(b). Again, specific authority is provided for the Secretary (under section 865(j)(2)) to write regulations for sourcing of income from trading in futures contracts, forward contracts, options contracts, and other instruments; Treasury, however, has not exercised this authority.

spread. Because financial inventory often trades in volatile markets, changes in market prices can have a significant effect on the profits a dealer makes.

Dealers that do not hold inventory are those that offer to enter into or otherwise transact in derivatives with customers. These dealers make their profit from fees charged to customers.

Before 1993, dealers in securities could elect to account for their inventories according to (1) the lower of cost or market, (2) cost, or (3) fair market value. In 1993, Congress provided a uniform rule for the taxation of securities held by securities dealers of all types, providing generally that a security that is inventory is included in inventory at the close of the taxable year at its fair market value, and all other securities held at the close of the taxable year are marked to market—that is, they are treated as sold on the last business day of the taxable year at their fair market value.⁴⁵

The character of gain or loss from the mark to market or the disposition of a security under section 475 is ordinary.⁴⁶

Security is defined broadly to include stocks, interests in widely held or publicly traded partnerships and trusts, debt instruments, interest rate swaps, currency swaps, and equity swaps, as well as options, forwards, and short positions on any of the above-mentioned financial instruments, and other positions identified as hedges with respect to any of the above-mentioned instruments. Section 1256 contracts are excluded.⁴⁷

A dealer in securities is also broadly defined as a taxpayer that (1) regularly purchases securities from, or sells securities to, customers in the ordinary course of business, or (2) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of business.⁴⁸

There are three exceptions to the mark-to-market rules:

- Securities held, and properly identified as, for investment;⁴⁹
- Debt originated or entered into in the ordinary course of a securities dealer's business that is not held for sale and that is properly identified as such,⁵⁰ and

⁴⁵ Sec. 475(a).

⁴⁶ Sec. 475(c)(3).

⁴⁷ Sec. 475(c)(2).

⁴⁸ Sec. 475(c)(1).

⁴⁹ Sec. 475(b)(1).

⁵⁰ Sec. 475(b)(2).

- Hedges entered into by a dealer of positions that are not securities or of securities that are not required to be marked to market.⁵¹

Section 475 allows traders in securities and dealers and traders in commodities to elect to be treated in the same manner as dealers in securities.⁵²

Almost all derivative trades in the United States have on at least one side either an exchange or a taxpayer that is subject to section 475. As a result, for more than 25 years, at least one party to almost all derivative trades in the United States has been subject to mark-to-market taxation.

Combinations of financial positions

The Federal income tax law generally treats financial positions as independent; thus, in general, one financial position does not affect the taxation of another. However, the financial consequence of entering into a combination of positions may differ from entering into any one position in isolation. As the disparity between the economic outcome of combining positions and the tax outcome of treating them separately became known, legislation and administrative guidance have on occasion provided for the taxation of transactions in financial positions while considering what else a taxpayer has in its portfolio. These rules for combinations of positions have been added to the Code and regulations in a piecemeal fashion.

Examples of the rules for combinations of financial positions (several of which are discussed in more detail below) include:

- Straddle rules in section 1092;
- Business hedging rules in section 1221;
- Short sale rules in section 1233;
- Rules for certain traded contracts in section 1256;
- Conversion rules in section 1258;
- Constructive sale rules in section 1259;
- Constructive ownership rules in section 1260;
- Debt hedging rules in Treas. Reg. sec. 1.1275-6; and
- Foreign currency hedging rules in section 988.

⁵¹ Sec. 475(b)(1)(C).

⁵² Sec. 475(e) and (f).

Straddles⁵³

“Straddle shelters” were transactions involving futures contracts entered into to accelerate recognition of loss, defer recognition of gain, and convert ordinary income into long-term capital gain in an era of large differences between the highest rates on ordinary income and long-term capital gain.

The advantages of entering into straddle shelters were curtailed beginning in 1981 by the enactment of a set of related laws, including sections 1092 and 1256. With their broad, sometimes uncertain meaning, these provisions potentially apply to a wide range of assets and transactions in an attempt to govern contracts that provide taxpayers significant flexibility in defining their economic exposure in the context of an income tax system (1) that is generally designed for property with less flexible features, (2) that relies on disposition as the primary signal to tax property transactions, and (3) in which the distinction between ordinary income and capital gain is based on the legal form of transactions rather than their economic substance.

Section 1092

A straddle is a set of offsetting positions with respect to personal property of a type that is actively traded.⁵⁴ Positions are offsetting if there is a “substantial diminution of risk of loss” from holding any position in actively traded property by holding one or more other positions with respect to actively traded property.⁵⁵ The term “substantial diminution of risk of loss” is central to the application of section 1092, but is not defined in the Code and its meaning has been uncertain since enactment.

Actively traded personal property is any personal property for which there is an established financial market.⁵⁶ Regulations defining “established financial market” take an expansive view of the term. A position is an interest in personal property, including a futures contract, a forward, or an option.⁵⁷ A notional principal contract constitutes property of a type that is actively traded if contracts based on the same or substantially similar indices are purchased, sold, or entered into on an established financial market. The rights and obligations of a party to a notional principal contract are rights and obligations with respect to personal property and constitute an interest in personal property.⁵⁸ A position does not need to be actively traded to be part of a straddle; only the property that underlies the position needs to be.

⁵³ See generally “Examining the Straddle Rules after 25 Years,” *Tax Notes*, 123 TN 1301 (Dec. 21, 2009) and Practising Law Institute, *Taxation of Financial Products and Transactions*, Matthew A. Stevens (ed.), 2013.

⁵⁴ Sec. 1092(c)(1) and (d)(1).

⁵⁵ Sec. 1092(c)(2)(A).

⁵⁶ Treas. Reg. sec. 1.1092(d)-1(a).

⁵⁷ Sec. 1092(d)(2).

⁵⁸ Treas. Reg. sec. 1.1092(d)-1(c).

Loss deferral

Loss on one leg of a straddle is not allowed to the extent a taxpayer has unrecognized gain with respect to an offsetting position.⁵⁹

A taxpayer's loss with respect to one position that is part of a straddle may only be taken into account to the extent that the loss exceeds the taxpayer's unrecognized gain with respect to any offsetting position that is part of the straddle.⁶⁰ The taxpayer may carry forward any disallowed loss into succeeding taxable years.⁶¹

Exceptions from the straddle rules are provided for hedging transactions,⁶² straddles composed entirely of section 1256 contracts,⁶³ and qualified covered calls.⁶⁴ Special rules apply to mixed straddles (generally, straddles comprised of both section 1256 contracts and non-section 1256 contracts)⁶⁵ and identified straddles.⁶⁶

⁵⁹ Sec. 1092(a)(1)(A).

⁶⁰ Sec. 1092(a)(1)(A).

⁶¹ Sec. 1092(a)(1)(B).

⁶² Sec. 1092(e). A hedging transaction is a transaction entered into in the normal course of the taxpayer's trade or business primarily to manage the risk of price changes or currency fluctuations with respect to ordinary property held by the taxpayer or to manage the risk of interest rate changes, price changes, or currency fluctuations with respect to borrowings made or ordinary obligations incurred by the taxpayer. Sec. 1221(b)(2)(A). To qualify for the exception, the hedging transaction must be clearly identified as such before the close of the day on which the transaction was entered into. Sec. 1256(e)(2).

⁶³ Sec. 1256(a)(4).

⁶⁴ Sec. 1092(c)(4); Treas. Reg. sec. 1.1092(c)-1(b). In general, a qualified covered call is any option granted by a taxpayer to buy stock held by the taxpayer but only if (i) such option is traded on a national securities exchange, (ii) such option is granted more than 30 days before the day on which the option expires, (iii) such option is not a deep-in-the-money option (as defined in section 1092(c)(4)(C)), (iv) such option is not granted by an options dealer in connection with dealing in options, and (v) gain or loss with respect to such option is not ordinary income or loss.

⁶⁵ Sec. 1092(b)(2). If a straddle consists of positions that are section 1256 contracts and non-section 1256 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 regulations designed to prevent the deferral of tax or the conversion of short-term capital gain into long-term capital gain or the conversion of long-term capital loss into short-term capital loss.

⁶⁶ Sec. 1092(a)(2). If a taxpayer clearly identifies a straddle as such before the close of the day on which the straddle is acquired, then the loss deferral rules of section 1092(a) do not apply. Instead, any loss incurred with respect to a position that is part of an identified straddle is added to the tax basis of the offsetting positions in the straddle. Sec. 1092(a)(2)(A); William R. Pomierski, "Identified Straddles: Uncertainties Resolved and Created by 2007 Technical Corrections," *Journal of Taxation of Financial Products*, vol. 7, no. 2, 2008, pp. 5-10, 55-57.

Holding periods

A taxpayer's holding period on a position does not run while the position is part of a straddle. If the position had already attained long-term holding status before it became part of the straddle, then the position retains its long-term holding status while the position is part of the straddle.⁶⁷

Carrying costs

Interest on debt and other carrying costs paid or incurred to purchase or carry property that is part of a straddle that is greater than interest and related income of a taxpayer is not deductible and goes to the capital account of the property.⁶⁸

Section 1256

To prevent future attempts to design straddles that might escape the rules in section 1092, Congress simultaneously enacted section 1256 to treat regulated futures contracts, which Congress viewed as vulnerable to abuse, from being viable components of a straddle shelter.⁶⁹ Section 1256, which has been expanded since 1981 to include additional types of contracts, provides special timing and character rules for certain derivatives. Any section 1256 contract held by a taxpayer at the close of a taxable year is marked to market; that is, the contract is treated as having been sold by the taxpayer for its fair market value on the last business day of the taxable year.⁷⁰ The character of gain or loss on the mark to market, or if the contract is terminated or transferred,⁷¹ is 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss, regardless of the taxpayer's holding period.⁷² Foreign currency contracts that are governed by both sections 1256 and 988 have more complex character rules.

A section 1256 contract is defined as any (1) regulated futures contract, (2) foreign currency contract, (3) nonequity option traded on or subject to the rules of a qualified board or exchange, (4) equity option purchased or granted by an options dealer that is listed on a qualified board or exchange on which the dealer is registered, or (5) securities futures contract entered into by a dealer that is traded on a qualified board or exchange.⁷³ Excluded from the definition of a

⁶⁷ Treas. Reg. sec. 1.1092(b)-2T(a)(1).

⁶⁸ Sec. 263(g).

⁶⁹ See Joint Committee on Taxation, *General Explanation of the Economic Recovery Act of 1981* (JCS-71-81) December 29, 1981, P. 294.

⁷⁰ Sec. 1256(a)(1).

⁷¹ Sec. 1256(c)(1).

⁷² Sec. 1256(a)(3). This general rule does not apply to section 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.

⁷³ Sec. 1256(b)(1). For definitions of these terms, see section 1256(g).

section 1256 contract is any (1) securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract, and (2) 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.⁷⁴

The scope of the term “foreign currency contract” has long been the subject of controversy, with the result that foreign currency forwards on major currencies are marked to market, but the tax treatment of foreign currency options is uncertain,⁷⁵ making foreign currency derivatives one example of how the tax treatment of derivatives with similar economic substance may differ based on the form of the derivative.⁷⁶

Business hedges

Nonfinancial businesses may use derivatives to manage (among other things) changes in prices of inputs, interest rates on borrowings, foreign currency fluctuations, revenue streams, and factors that could affect profits (*e.g.*, weather).

Section 1221(b)(2) defines a hedging transaction as any transaction entered into in the normal course of a taxpayer’s trade or business primarily to manage risk of price changes or currency fluctuations with respect to ordinary property held or to be held by the taxpayer, or to manage risk of 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 such other risks as the Secretary prescribes in regulations.

The regulations under section 1221 provide that whether a transaction is “primarily to manage risk” is a determination based on all the facts and circumstances surrounding the taxpayer’s business and the transaction.⁷⁷ The regulations provide several examples of risk management activity. Only those hedges that fall within the statutory definition are given ordinary treatment. The definition of business hedge, however, does not cover hedges of revenue, dividend, or royalty streams, profit margin hedging, or hedging of capital assets. Arrangements that hedge the gap between a taxpayer’s liabilities and the assets purchased to meet the taxpayer’s obligations are also not covered by the definition of business hedge, unless such hedges can be shown to be hedges of the taxpayer’s liabilities.

⁷⁴ Sec. 1256(b)(2).

⁷⁵ The tax treatment of foreign currency options that form part of a tax shelter has been the subject of litigation. See, *e.g.*, *Wright v. Commissioner*, 809 F.3d 877 (6th Cir. 2016).

⁷⁶ For a report on practitioner debate on this matter, see “Taxpayers Win in Indecision Over Foreign Currency Options” Daily Tax Report, 47 DTR G-3 (March 10, 2016) and “Court Decision Spurs Foreign Currency Option Treatment Debate,” *Tax Notes* (March 14, 2016).

⁷⁷ Treas. Reg. sec. 1.1221-2(c)(4)(i).

Taxpayers are required to identify hedging transactions and the items being hedged by the close of the day on which the taxpayer enters into the hedging transaction.⁷⁸ The identification must be made on, and retained as part of, the taxpayer's books and records.⁷⁹ The identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this requirement unless the taxpayer's books and records indicate that the nontax identification is also being made for tax purposes.⁸⁰

Timing of hedging gains and losses

Regulations under section 446 provide that taxpayers must account for gains and losses from hedging transactions in a manner that clearly reflects income, which the regulations define as reasonably matching the timing of income, deduction, gain, or loss from the hedging transaction with the income, deduction, gain, or loss from the risk being hedged.⁸¹ That is, the timing on the hedge follows the timing on the hedged item. When a taxpayer enters into a hedge on an item and disposes of the item but does not dispose of the hedge, the built-in gain or loss on the hedge must be matched to the gain or loss on the item that has been disposed of, a requirement that may be met by marking the hedge to market on the day of the disposition.⁸²

Constructive sales

Section 1259 generally requires a taxpayer to recognize gain upon a constructive sale of an appreciated financial position with respect to any stock, debt instrument,⁸³ or partnership interest. The legislative history indicates that Congress had "anticipated that the Treasury [would] use the provision's authority to treat as constructive sales other financial transactions that . . . have the effect of eliminating substantially all of the taxpayer's risk of loss and opportunity for income or gain with respect to the appreciated financial position."⁸⁴

Section 1259 does not explicitly state that entering into an option, or combination of options, triggers the requirement to realize gain, perhaps because a single option would not "have the effect of eliminating" substantially all of the taxpayer's risk of loss and opportunity for income or gain with respect to a position. The legislative history notes that combinations of options, such as put and call options on the same underlying with the same or close strike prices,

⁷⁸ Treas. Reg. sec. 1.1221-2(f)(1).

⁷⁹ Treas. Reg. sec. 1.1221-2(f)(4)(i).

⁸⁰ Treas. Reg. sec. 1.1221-2(f)(4)(ii).

⁸¹ Treas. Reg. sec. 1.446-4(b).

⁸² Treas. Reg. sec. 1.446-4(e)(6).

⁸³ The term "appreciated financial position" does not include debt that is payable at a fixed rate or a qualifying variable rate and that is not convertible into stock of the issuer or a related person, or that is marked to market under some other rule. Sec. 1259(b)(2).

⁸⁴ Senate Finance Committee Report on the Revenue Reconciliation Bill of 1997 (S. 949), S. Rep. No. 105-33, 105th Cong., 1st Sess. 127 (Comm. Print 1997) at p. 126.

and “in-the-money” options (*e.g.*, a put option where the strike price is significantly above the current market price of the referenced underlying) may have substantially the same effect as the financial positions addressed by section 1259.⁸⁵ The legislative history anticipates Treasury guidance addressing proper treatment of such positions under section 1259.⁸⁶ To date, no such regulations have been published.

While both sections 1092 and 1259 address capital hedging transactions (*i.e.*, when a taxpayer has a capital asset and a derivative that hedges some part of the financial risk of owning the asset), each section provides for a different test and result. Section 1092 provides for loss deferral (and other consequences) when one position results in a substantial diminution of risk of loss in another position. Section 1259 provides for gain recognition when entering into one position has the effect of eliminating loss and gain potential in another position. In contrast, section 1221 provides for special character and timing rules for the hedge (which would otherwise be a capital asset) when it is entered into for the purpose of managing risk on ordinary business assets and activities. These tax rules applicable to combinations of positions differ from the tax rules applicable to assets or derivatives when held on their own.

Insurance companies holding debt

Insurance companies are subject to Federal income tax computed under section 11, which is the tax imposed on corporations in general. In the case of a life insurance company, however, the base is life insurance company taxable income, as opposed to taxable income.⁸⁷

A capital asset is property held by the taxpayer whether or not connected with the taxpayer’s trade or business, subject to certain exceptions.⁸⁸ Insurance companies are not treated as financial institutions for purposes of the rule that the sale or exchange by a financial institution of a bond, debenture, note, or certificate or other evidence of indebtedness is not considered the sale or exchange of a capital asset.⁸⁹ Thus, such an asset generally is treated as a capital asset in the hands of an insurance company, even if the asset is connected with the company’s trade or business of insurance.

Regulated investment companies

Regulated investment companies (“RICs”) are taxable on their investment company taxable income, as defined in section 852(b)(2). A RIC may not claim a net operating loss

⁸⁵ *Ibid.*, pp. 126-127.

⁸⁶ *Ibid.*, p. 127.

⁸⁷ Secs. 801(a) and 831(a).

⁸⁸ Sec. 1221.

⁸⁹ Sec. 581(c).

deduction (as provided under section 172) in calculating its investment company taxable income.⁹⁰

Exchange by a corporation of its own stock

No gain or loss is recognized by a corporation on the receipt of money or other property in exchange for its own stock.⁹¹ Furthermore, no gain or loss is recognized by a corporation with respect to any lapse or acquisition of an option, or with respect to a securities futures contract (as defined in section 1234B), to buy or sell its stock.⁹² This rule has been interpreted by some taxpayers to permit a corporation to obtain a tax-free interest-like return by simultaneously repurchasing its own stock and entering into a forward contract to sell the same number of shares at a fixed price equal to the current market value (*i.e.*, the repurchase price paid by the corporation) plus a return reflecting the time value of money.⁹³

⁹⁰ Sec. 852(b)(2).

⁹¹ Sec. 1032(a).

⁹² *Ibid.*

⁹³ New York State Bar Association, Tax Section, "Report on Section 1032," 1999, pp. 6-7.

DESCRIPTION OF MODA

In general

MODA unifies and simplifies the treatment of derivatives, providing one timing rule, one character rule, and one sourcing rule for all derivatives. MODA expands the scope of the mark-to-market timing rule to a broader class of taxpayers and arrangements than has been subject to such a rule in the past. Gain or loss from derivatives and certain related assets is treated as ordinary income or loss. Finally, the flows on derivatives generally are sourced to the country of residence, incorporation, or organization of the taxpayer.

Definition of derivative

In general

A derivative is defined as any contract the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more of the following: (1) any share of stock in a corporation; (2) any partnership or beneficial ownership interest in a partnership or trust; (3) any evidence of indebtedness; (4) any real property (other than real property for which an exclusion is available, which is discussed further below); (5) any commodity that is actively traded within the meaning of section 1092; (6) any currency; (7) any rate, price, amount, index, formula, or algorithm; and (8) any other item prescribed by the Secretary. For this purpose, the term “contract” includes any option, forward, future, short position, swap, or similar contract. The term “derivative” does not include any item described in (1) through (8), except as otherwise provided by the Secretary to prevent the avoidance of the purposes of MODA.⁹⁴

The term derivative includes an embedded derivative component. If a contract has both derivative and nonderivative components, then each derivative component is treated as a separate derivative. If derivative component embedded in a contract cannot be valued separately from the contract, the entire contract that includes the embedded derivative component is treated as a derivative. A debt instrument is not treated as having an embedded derivative component merely because it is denominated in a nonfunctional currency or because payments with respect to such debt instrument are determined by reference to the value of a nonfunctional currency.

Exclusions from definition of derivative

MODA excludes the following contracts from the definition of derivative.

1. American depository receipts: American depository receipts (and similar instruments) with respect to shares of stock in a foreign corporation that are treated as shares of stock in such foreign corporation, except as otherwise provided by the Secretary;

⁹⁴ Section 493, as added by section 2 of MODA.

2. Certain contracts with respect to real property: any contract with respect to interests in real property (as defined in section 856(c)(5)(C)) if the contract requires physical delivery of the real property;⁹⁵
3. Hedging transactions: any contract that is part of a hedging transaction within the meaning of section 1221(b), as amended by MODA, or section 988(d)(1), as amended by MODA;
4. Certain financing transactions: to the extent provided by the Secretary, any arrangement in which a taxpayer has the right to the return of the same or substantially identical securities transferred in a securities lending transaction, a sale-repurchase transaction, or similar financing transaction;⁹⁶
5. Options received in connection with the performance of services: any option described in section 83(e)(3) received in connection with the performance of services;
6. Insurance contracts, annuities, and endowments: any insurance, annuity, or endowment contract issued by an insurance company to which subchapter L applies (or issued by any foreign corporation to which such subchapter would apply if the foreign corporation were a domestic corporation).
7. Derivatives with respect to stock of members of the same worldwide affiliated group: any contract that is otherwise within the definition of derivative is not treated as a derivative if it is with respect to stock issued by any member of the same worldwide affiliated group of which the taxpayer is a member; and
8. Commodities used in the normal course of a trade or business: any contract with respect to any commodity if (1) the contract requires physical delivery, with the option of cash settlement only in unusual and exceptional circumstances, and (2) the

⁹⁵ This exclusion from the definition of a derivative is provided so that common residential and commercial real estate transactions that are pending at the end of a taxable year are not subject to the general rule for derivatives. For example, under this exception, an option to buy or sell a residential or commercial property is not a derivative subject to MODA, provided that the option requires physical delivery of the residential or commercial property (as opposed to cash settlement). For this purpose, a contract that provides for the option of cash settlement nonetheless is treated as requiring physical delivery of real property if the option of cash settlement is exercisable only in unusual and exceptional circumstances. This exception includes contracts that facilitate the sale or purchase of physically delivered real property. For example, MODA would treat a residential mortgage interest rate lock entered into by an individual as a contract with respect to interests in real property requiring physical delivery because the interest rate contract is related to the purchase of real property that will be physically delivered, even though real property is not physically delivered under the interest rate contract itself.

⁹⁶ A securities lending transaction is a transfer of one or more securities (as defined in section 1058(c), as amended by section 4(a)(3)(C) of MODA) or a substantially similar transaction. A sale-repurchase transaction is an agreement pursuant to which one party transfers securities to a counterparty in exchange for cash and simultaneously agrees to transfer cash to the counterparty in the future in exchange for substantially identical securities. A “similar financing transaction” is one that serves the same purpose as, and is economically equivalent to, a securities lending or a sale-repurchase transaction. The Secretary may provide rules regarding a securities lending transaction, sale-repurchase transaction, or similar financing transaction whether such transaction involves a privately negotiated, bilateral derivative or a centrally cleared, exchange-traded derivative.

commodity is used in, and the derivative relates to quantities normally used in, the normal course of the taxpayer's trade or business.⁹⁷

Timing rules for derivatives⁹⁸

If there is a “taxable event” (discussed below) with respect to a derivative, MODA requires that gain or loss be recognized and taken into account in the year the taxable event occurs. Any gain or loss taken into account as a result of subsequent taxable events with respect to the derivative is determined only after proper adjustment has been made for gain or loss recognized as a result of any prior taxable event. In this way, taxable events with respect to a derivative are linked by adjustments made in successive periods through the life of the derivative. Regardless of a taxpayer's overall method of accounting, any payment with respect to a derivative that does not constitute a taxable event is taken into account at the time the payment occurs, and proper adjustment must be made to the amount of any subsequent gain or loss with respect to the derivative as a result of such payment.

MODA provides for two types of taxable events for derivatives that are not part of an “investment hedging unit” (discussed below): (1) the close of the taxable year if a taxpayer has rights or obligations with respect to a derivative at such time; and (2) the termination or transfer of a derivative during the taxable year. For this purpose, the termination or transfer of a derivative includes, but is not limited to, any termination or transfer by offsetting, by taking or making delivery, by exercise or being exercised, by assignment or being assigned, by lapse, by sale or other disposition, by assumption, or otherwise.

The amount of gain or loss taken into account on the occurrence of a taxable event is (1) in the case of a termination or transfer of a derivative, the amount of gain or loss that would otherwise be determined under the Code, and (2) in all other cases, the amount that would have been taken into account had the taxable event been a termination or transfer.

When the taxable event is the close of the taxable year in which the taxpayer has a right or obligation with respect to a derivative, the taxpayer is required to determine the fair market value of the derivative as if it had been terminated or transferred at that time. It is intended that taxpayers use sources of information and valuation methods consistently from period to period to determine the fair market value, incorporating developments in the financial markets and advances in financial engineering in a reasonable and fair manner.

For these purposes, the taxpayer may rely on valuations provided by a broker under section 6045(b). In addition, a taxpayer may rely on nontax reports and statements for valuation of a derivative. MODA requires taxpayers to prioritize the use of certain reports and statements if they are available (“applicable financial statements”).

⁹⁷ In the case of an individual, there is also an exception for a contract with respect to a commodity if the commodity is used for personal consumption.

⁹⁸ Section 491, as added by section 2 of MODA.

First, a taxpayer must use financial statements certified as being prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). Taxpayers must prioritize financial statements in the following order: (1) a Form 10-K (or successor form) or annual statement to shareholders required to be filed by the taxpayer with the U.S. Securities and Exchange Commission (“SEC”); (2) if no statement described in (1) is available, an audited financial statement given to creditors to make lending decisions, reporting to shareholders, partners, other proprietors or beneficiaries, or for other substantial nontax purposes; or (3) if no statements described in (1) or (2) are available, a statement filed by the taxpayer with any other Federal agency for purposes other than Federal tax purposes.

Second, if no audited GAAP financial statements are available, taxpayers may use financial statements prepared in accordance with international financial reporting standards (“IFRS”) required to be filed with agencies of a foreign government equivalent to the SEC in jurisdictions that have reporting standards at least as stringent as those in the United States.

Last, if neither audited GAAP financial statements nor financial statements prepared in accordance with IFRS are available, taxpayers may use statements provided to other regulatory or governmental bodies as provided by the Secretary.

Investment hedging units (“IHUs”)⁹⁹

MODA provides a comprehensive regime for a taxpayer that simultaneously has rights or obligations with respect to a derivative and owns the underlying investment referred to by the derivative, to the extent that the combinations of derivatives and underlying investments are not governed by some other rule (*e.g.*, business hedges under section 1221, as amended by MODA). MODA provides (1) for the harmonization of the disparate rules during the period a taxpayer has both rights or obligations with respect to a derivative and owns the underlying investment referred to by the derivative, (2) rules for a taxpayer that either owns an underlying investment and enters into a derivative contract or has rights or obligations with respect to a derivative and acquires the underlying investment, and (3) rules for a taxpayer that terminates or transfers its rights or obligations with respect to a derivative or disposes of the underlying investment. As a general matter, these rules prescribe circumstances under which the underlying investment referred to by the derivative is itself subject to MODA’s timing and character rules.

A taxpayer is treated as having an IHU during an applicable hedging period when it holds (1) one or more derivatives with respect to an underlying investment, and (2) any amount of the underlying investment that has a certain financial relationship with such derivative or derivatives (the “delta” or “delta relationship”). Delta means, with respect to any derivative and its underlying investment, the ratio of the expected change in the fair market value of the derivative to a very small change in the fair market value of the underlying investment. For a derivative and its underlying investment to comprise an IHU under MODA, the delta relationship between the derivative and the underlying investment must be within the range beginning with negative 0.7 (-0.7) and ending with negative 1.0 (-1.0) (the “delta test”). Thus, an IHU consists of (1) all derivatives with respect to an underlying investment that, alone or in combination, meet the delta

⁹⁹ Section 492, as added by section 2 of MODA.

test with respect to any amount of the underlying investment, and (2) the amounts of the underlying investment with respect to which such derivatives meet the delta test. A taxpayer is required to identify all derivatives with respect to which it holds an underlying investment and all underlying investments with respect to which it holds a derivative, and to identify which combinations of derivatives and underlying investments comprise an IHU (because they meet the delta test) and which do not.

Generally, the determination of what amounts of an underlying investment are part of an IHU must be made in the manner which results in the largest amount of such underlying investment being treated as part of an IHU. So, for example, if a taxpayer owns ten widgets and purchases a derivative with respect to widgets that has a delta of -0.8 when measured against eight widgets, a delta of -0.7 when measured against nine widgets, and a delta of -0.6 when measured against ten widgets, then nine widgets are treated as part of an IHU. The Secretary is permitted to simplify application of this rule to certain listed options¹⁰⁰ and regulated futures contracts.¹⁰¹

The delta test is to be conducted in a commercially reasonable manner consistent with the methods used in the preparation of a taxpayer's financial statements (except if the Secretary provides otherwise). In general, if the value of a derivative is determined by reference to two or more underlying investments, the delta test is applied separately with respect to each underlying investment. Further, the Secretary may by regulations provide methods for determining the delta of the derivative with respect to the underlying investments, and in the absence of guidance from the Secretary, the delta test is intended to be applied in a commercially reasonable manner.

Definition of underlying investment

An underlying investment with respect to any derivative is any item by reference to which the derivative's value is (or any payments or transfers under the derivative are) determined. As discussed above, under MODA, a derivative is any contract the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more of eight types of items (such items, "potential determinants"), but which itself is not a potential determinant.¹⁰² MODA therefore defines an underlying investment with

¹⁰⁰ MODA defines a listed option as any option (other than a right to acquire stock from the issuer) which is traded on (or subject to the rules of) a qualified board or exchange. A qualified board or exchange means: (1) a national securities exchange which is registered with the SEC; (2) a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission; or (3) any other exchange, board of trade, or other market which the Secretary determines has rules adequate to carry out the purposes of the rules added to the Code by MODA.

¹⁰¹ MODA defines a regulated futures contract as a contract with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market, and which is traded on (or subject to the rules of) a qualified board or exchange (as defined in the preceding footnote).

¹⁰² Those eight types of items are: (1) any share of stock in a corporation; (2) any partnership or beneficial ownership interest in a partnership or trust; (3) any evidence of indebtedness; (4) any real property (other than real property for which an exclusion is available); (5) any commodity that is actively traded within the meaning of section 1092; (6) any currency; (7) any rate, price, amount, index, formula, or algorithm; and (8) any other item

respect to a derivative as any potential determinant by reference to which the value of (or any payment or other transfer with respect to) the derivative is directly or indirectly determined.

If the taxpayer owns any share of stock or evidence of indebtedness the value of which (or amount of any payment or other transfer with respect to which) is primarily determined by reference to one or more potential determinants, then, for purposes of determining whether the taxpayer holds an underlying investment with respect to any derivative held by the taxpayer, the taxpayer shall be treated as holding the potential determinant itself. As a result, for example, if a taxpayer owns a share of stock in a corporation whose sole asset is an interest in a partnership, and the taxpayer purchases a put option on an interest in the same partnership, the share of stock in the corporation is treated as if it were an interest in the partnership for purposes of determining whether the taxpayer holds an underlying investment with respect to the option.

A potential determinant is not treated as indirectly determining the value of a derivative held by the taxpayer (and therefore is not treated as an underlying investment) merely because the change in a variable affecting the value of (or amount of any payment or other transfer with respect to) a derivative also affects the value, level, amount, or calculation of the potential determinant.

The following examples illustrate circumstances in which the potential determinant in the example either is or is not intended to be treated as indirectly determining the value of (or amount of any payment or other transfer with respect to) the derivative in the example.

Example 1.—A taxpayer owns stock in corporation A, whose primary asset is gold. The taxpayer buys a put option on stock in corporation B, whose primary asset is gold. The value of the put option is indirectly determined by reference to gold. Because the value of the taxpayer’s stock in corporation A is primarily determined by reference to gold, the taxpayer is treated as if it directly held gold. Thus, the taxpayer’s corporation A stock is treated as an underlying investment with respect to the taxpayer’s put option on corporation B.

Example 2.—A taxpayer owns stock in an exchange traded fund (“ETF”) that tracks the S&P 500. The taxpayer buys a put option on stock in another ETF that tracks the S&P 500. The value of the put option is indirectly determined by reference to the S&P 500. Because the value of the taxpayer’s ETF stock is primarily determined by reference to the S&P 500, the taxpayer is treated as if it directly held the S&P 500. Thus, the taxpayer’s ETF stock is treated as an underlying investment with respect to the taxpayer’s put option on the other ETF.

Example 3.—A taxpayer owns stock in ABC, a publicly traded, multinational corporation. The taxpayer buys a put option on stock in DEF, another publicly traded, multinational corporation that is unrelated to ABC. The two corporations operate in the same industry, and, historically, changes in the values of their stocks have been highly correlated to shocks that affect the industry generally. It is not intended that the value of the option be treated as indirectly determined by reference to the ABC stock.

prescribed by the Secretary. For this purpose, any item substantially the same as any enumerated item is also a potential determinant.

Example 4.—A taxpayer owns stock in an ETF that tracks the S&P 500. The taxpayer buys a put option on stock in another ETF that tracks the Russell 3000. Historically, changes in the values of the S&P 500 and the Russell 3000 have been highly correlated. It is not intended that the value of the option be treated as indirectly determined by reference to the stock of the ETF that tracks the S&P 500.

Example 5.—A taxpayer owns stock in a corporation that manufactures and sells processed snack foods. The corporation regularly purchases corn on the open market as an important input in its production process. Anticipating that the price of corn will increase in the coming months as a result of global weather trends that will affect the American corn harvest, the taxpayer purchases call options on corn. A change in the price of corn would affect the value of both the stock and the options. It is not intended that the value of the options be treated as indirectly determined by reference to the stock of the corporation.

Establishment of an IHU

IHUs are formed in three ways and may be governed by two different accounting methods. As described below, an IHU is formed when one or more derivatives and underlying investments or parts thereof (1) meet the delta test and are identified by the taxpayer, (2) are treated as an IHU by election of the taxpayer, or (3) meet the delta test without taxpayer identification.

Identifying derivatives and underlying investments

Derivatives and their underlying investments are required to be tested for the delta relationship and taxpayers are required to make certain identifications:

1. at the beginning of any period the taxpayer simultaneously holds one or more derivatives with respect to any underlying investment and any amount of the underlying investment (together, a “derivative/underlying combination”);
2. during the period in which the taxpayer has rights or obligations with respect to a derivative/underlying combination
 - a. immediately after the taxpayer enters into another derivative with respect to the underlying investment,
 - b. immediately after the taxpayer acquires an additional amount of the underlying investment,
 - c. immediately after the taxpayer terminates or transfers its rights or obligations with respect to one or more derivatives with respect to the underlying investment, and
 - d. immediately after the taxpayer sells or exchanges any amount of the underlying investment; and
3. at such other times during such period as the Secretary may prescribe.

At such times, the taxpayer is required to identify both derivative/underlying combinations that meet the delta test and derivative/underlying combinations that do not meet the delta test. Except as provided by the Secretary, no testing or identification at any time other than the times listed above is taken into account.

Electing to establish an IHU

A taxpayer may elect to treat any derivative/underlying combination as an IHU (an “IHU election”). An IHU election applies to all of the underlying investment owned by the taxpayer and all derivatives with respect to the underlying investment held by the taxpayer after the election is made, whether or not the derivatives and the underlying investment are held simultaneously. The election is irrevocable.

Taxpayers failing to identify an IHU or make an election with respect to an IHU

If a taxpayer has rights or obligations with respect to a derivative/underlying combination and the taxpayer (1) fails to make the identifications required for such derivative/underlying combination, and (2) fails to make an IHU election with respect to such derivative/underlying combination, then the taxpayer is treated as having made an IHU election as of the first time the taxpayer has positions which together form a derivative/underlying combination. The election may be revoked only with the consent of the Secretary.

Identifications and elections described above are expected to form part of the taxpayer’s books and records.

Timing rules for positions in an IHU

The following are taxable events with respect to all derivatives and underlying investments that are part of an IHU: (1) the establishment of the IHU; (2) the termination or transfer of any such derivative; (3) the sale or exchange of all or any amount of any such underlying investment; (4) after the establishment of the IHU, the entering into of another derivative or the acquisition of an additional amount of such underlying investment if either is treated as part of the IHU; (5) in the case of an IHU with respect to which the taxpayer has made an election, or is treated as having made an election, under proposed section 492(b) (relating to items included in the IHU), the close of each business day; and (6) in the case of any other IHU, the close of any taxable year in which the taxpayer has an IHU.

The amount of gain or loss on the occurrence of a taxable event for an IHU is: (1) in the case of a termination or transfer of a derivative, the amount of gain or loss that would otherwise be determined under the Code; (2) in the case where there is a taxable event with respect to a derivative that is not a termination or transfer, the amount that would have been taken into account had the taxable event been a termination or transfer; (3) in the case where an underlying investment is sold or exchanged, the amount of gain or loss that would otherwise be determined under the Code; and (4) in the case where there is a taxable event with respect to an underlying investment that is not a sale or exchange, the amount that would have been taken into account had the taxable event been a sale or exchange.

When a taxpayer establishes an IHU, or when positions are added to an IHU, no built-in loss is recognized with respect to any position in the IHU. Built-in gain with respect to any position, however, is recognized and realized when a taxpayer establishes an IHU, or adds positions to an IHU, and the gain has the character it would have had if the item had been sold or exchanged, terminated, or transferred under general tax principles.

Character of income, deductions, gains, and losses on derivatives and underlying investments

Any item of income, deduction, gain, or loss taken into account with respect to a derivative or an underlying investment that is part of an IHU is treated as ordinary income or loss and is treated as attributable to the trade or business of the taxpayer for purposes of section 62(a) (relating to the adjusted gross income of an individual) and section 172(d)(4) (relating to the limitation on nonbusiness deductions of taxpayers other than corporations in computing a net operating loss). Thus, such deductions and losses reduce adjusted gross income and are taken into account in full in computing net operating losses.

For any underlying investment that is part of an IHU, any built-in gain¹⁰³ with respect to the underlying investment is treated as long-term or short-term capital gain if the built-in gain would have been so treated if the underlying investment were sold or exchanged at its fair market value immediately before the later of (1) the time that the IHU was established or (2) the time the underlying investment became part of the IHU.

The taxpayer's holding period with respect to any underlying investment that is part of an IHU does not include any period during which the underlying investment is part of the IHU.

Source of gain or loss from derivatives

Any item of income, deduction, gain or loss taken into account with respect to a derivative is treated as derived from sources within the country of residence, incorporation, or organization of the taxpayer, except to the extent that section 871(m) applies to payments with respect to a derivative. This source rule is not intended to affect the determination of whether income is effectively connected with the conduct of a U.S. trade or business.

Contracts similar to derivatives

If there is a taxable transaction with respect to a right or obligation with respect to property other than a derivative or a position in certain property to which section 1092 applies, then gain or loss attributable to that transaction is considered gain or loss from the sale or exchange of property which has the same character as the property to which such right or obligation relates has (or would have) in the hands of the taxpayer.¹⁰⁴ For this purpose, a taxable

¹⁰³ Built-in gain is any gain that would have been recognized and taken into account if the underlying investment were sold or exchanged at its fair market value immediately before the later of (1) the time that the IHU was established or (2) the time the underlying investment became a component of the IHU.

¹⁰⁴ This treatment applies notwithstanding any other provision of the Code, other than section 1032.

transaction is (1) any termination or transfer of such interest or (2) any payment in fulfillment or partial fulfillment of such interest.

Straddles

MODA provides that loss on one leg of a straddle is not to be taken into account to the extent a taxpayer has unrecognized gain in an offsetting position—that is, a taxpayer’s loss with respect to a position that is part of a straddle may only be taken into account to the extent that the amount of such loss exceeds the taxpayer’s unrecognized gain (if any) with respect to any offsetting positions that are part of the straddle. The taxpayer may carry forward any disallowed loss into succeeding taxable years.

A straddle is defined as offsetting positions with respect to applicable property, that is, items that are (1) described in section 493(a) (other than real property), and (2) of a type which is actively traded. A taxpayer holds offsetting positions with respect to applicable property if the taxpayer holds a position which, by itself or in combination with one or more other positions held by the taxpayer, has a delta relationship with respect to any other position held by the taxpayer which is within the range beginning with -0.7 and ending with -1.0. In calculating delta for these purposes, positions are taken into account whether or not they are in the same applicable property. The delta relationship means, with respect to any two or more positions, the ratio of the expected change in the fair market value of one position to a very small change in the fair market value of one or more other positions. The delta must be determined in a commercially reasonable manner consistent with the methods used in the preparation of a taxpayer’s financial statements (except if the Secretary provides otherwise). In determining whether two or more positions are offsetting, the taxpayer is treated as holding any position held by a related party.¹⁰⁵ Additionally, if part or all of the gain or loss with respect to a position held by a partnership, trust, or other entity would properly be taken into account by the taxpayer, then the taxpayer is treated as holding that position unless otherwise provided in regulations by the Secretary.

A position is defined as an interest in applicable property and does not include a derivative, but it does include an interest in a nonfunctional currency denominated debt obligation (which is treated as a position in the nonfunctional currency). For these purposes, a

¹⁰⁵ Under section 492(f), as added by section 2 of MODA, a person is a related party with respect to the taxpayer if such person (1) is the taxpayer’s spouse, (2) is a dependent of the taxpayer or any other taxpayer with respect to whom the taxpayer is a dependent, (3) is an individual, corporation, partnership, trust, or estate which controls, or is controlled for purposes of section 954(d)(3) by the taxpayer or any individual described in (1) or (2) with respect to the taxpayer, (4) is an individual retirement account, an Archer MSA (as defined in section 220(d)), or a health savings account (as defined in section 223(d)) of the taxpayer or any individual described in (1) or (2) with respect to the taxpayer, (5) is one of the types of education savings accounts described in sections 529, 529A(f)(6), or 530(b) if the taxpayer or any individual described in (1) or (2) with respect to the taxpayer 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, (6) is an account, plan, or contract described in sections 401(a), 403(a), 403(b), or 457(b) (provided such plan described in section 457(b) is maintained by an employer described in section 457(e)(1)(A)) 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, or (7) files a consolidated return (within the meaning of section 1501) with the taxpayer for any taxable year which includes a part of such period.

foreign currency for which there is an active interbank market is presumed to be actively traded. As under present law, a position does not need to be actively traded to be part of a straddle; only the property that underlies the position needs to be.

Hedging transactions¹⁰⁶ and IHUs are not subject to the straddle rules.

Transactions by a corporation with respect to its stock

No gain or loss is recognized to a corporation on the receipt of money or other property in exchange for its own stock. MODA further provides that “section 1032 derivative items” are not taken into account in determining a corporation’s liability for Federal income tax. A section 1032 derivative item is any item of income, gain, loss, or deduction if (1) such item arises out of the rights or obligations under any derivative to the extent such derivative relates to the corporation’s stock (or is attributable to any transfer or extinguishment of any such right or obligation) or (2) such item arises under any other contract or position, but only to the extent that such item reflects (or is determined by reference to) changes in the value of such stock or distributions thereon. A section 1032 derivative item does not include any deduction to which section 83(h) applies or any deduction for any item which is in the nature of compensation for services rendered. MODA provides that section 1032, rather than part IV of subchapter E (*i.e.*, the new derivative and IHU rules described above) or section 1092, governs the treatment of section 1032 derivative items held by a corporation with respect to its stock, and that such section 1032 derivative items are not taken into account in determining whether a corporation has an IHU, an applicable property interest, or a straddle with respect to its stock for purposes of such part or section.

If a corporation acquires its stock as part of a plan (or series of related transactions) pursuant to which the corporation enters into a forward contract with respect to its stock, MODA requires that the corporation include in income the excess of the amount to be received under the forward contract over the fair market value of the stock as of the date the corporation entered into the forward contract as if such amount were original issue discount on a debt instrument. Unless it is established otherwise, a plan is presumed to exist if the corporation enters into a forward contract with respect to its stock within the 60-day period beginning on the date which is 30 days before the date the corporation acquired its stock.

Bonds of certain insurance companies treated as ordinary

MODA adds a new exception to the definition of a capital asset in the case of an applicable insurance company.¹⁰⁷ Specifically, a capital asset does not include any bond, debenture, note, or certificate or other evidence of indebtedness held by an applicable insurance company. To prevent selective changes to the character of an asset or character changes from

¹⁰⁶ As described above, a hedging transaction is a transaction entered into in the normal course of the taxpayer’s trade or business primarily to manage the risk of price changes or currency fluctuations with respect to ordinary property held by the taxpayer or to manage the risk of interest rate changes, price changes, or currency fluctuations with respect to borrowings made or ordinary obligations incurred by the taxpayer. Sec. 1221(b)(2)(A).

¹⁰⁷ Sec. 1221(a)(9), as added by section 3(c) of MODA.

year to year (*e.g.*, if a company is not an applicable insurance company every year), a rule is provided that if an asset is so treated with respect to an applicable insurance company for any taxable year, the asset is so treated during any subsequent taxable year the asset is held by the company. Regulatory authority is provided as may be necessary or appropriate to carry out the purposes of the provision, including to prevent the avoidance of Federal income tax through sale or exchange of assets described in the new exception.

An applicable insurance company means an insurance company that meets certain statutory requirements. First, it must be a company more than half the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.¹⁰⁸ Further, it must be subject to tax under section 801(a) or section 831(a). Insurance companies that are subject to any of the following provisions are not included in the definition of applicable insurance company: section 831(b) (relating to an election to be taxed only on taxable investment income), section 835 (relating to an election by a reciprocal underwriter), section 842 (relating to foreign companies carrying on insurance business), or section 833(a)(1) (treated as a stock insurance company).

RICs allowed net operating loss deduction

MODA revises section 852(b) to permit a RIC to claim a net operating loss deduction in calculating its investment company taxable income. A special rule provides that a net operating loss of a RIC may not be carried back to a prior taxable year for this purpose.

Effective Date

MODA is generally effective for taxable events occurring after the 90-day period beginning with the date of enactment, in taxable years ending after the last day of such period, and for and derivatives and underlying investments held after the last day of such period.

A transition rule applies to derivatives and underlying investments held as of the close of such 90-day period. A taxpayer simultaneously holding, as of the close of the 90-day period, one or more derivatives with respect to an underlying investment and the underlying investment must make the identifications required with respect to IHUs before the close of the period. If the derivative/underlying combination is an IHU, then the first applicable hedging period with respect to the IHU starts on the day after the close of the period.

With respect to debt instruments held by insurance companies, MODA is effective for any bond, debenture, note, or certificate or other evidence of indebtedness held or acquired after the 90-day period beginning with the date of enactment. A transition rule applies with respect to capital loss carryforwards to taxable years beginning after the close of the 90-day period beginning with the date of enactment. Under the transition rule, in addition to any other short-term capital gain of the taxpayer, the taxpayer treats as short-term capital gain (rather than ordinary income) an amount equal to the lesser of (1) the net gain (if any) from sales or exchanges during the taxable year of assets to which new section 1221(a)(9) applies, or (2) the

¹⁰⁸ Sec. 816(a).

capital loss carryovers to that taxable year from any taxable year beginning before the close of the 90-day period beginning with the date of enactment.