SECTIONS 3401 TO 3434: TAXATION OF FINANCIAL PRODUCTS

By Brion D. Graber and Peter H. Winslow

In January 2013, Chairman Camp released a discussion draft proposing changes to the tax treatment of financial products and invited comments on the draft.[1] The financial products proposal potentially having the greatest impact on life insurance companies related to the tax treatment of derivatives and required that they be marked to market. The comprehensive Tax Reform Discussion Draft released by Camp on Feb. 26, 2014 incorporated the earlier derivatives proposal, but with a key modification to address concerns raised by the insurance industry in response to the January 2013 draft. Before getting into these and other proposed changes to the taxation of financial products included in the comprehensive Tax Reform Discussion Draft, however, a little background on current tax law as it applies to life insurance company hedges is appropriate.

CURRENT LAW

An insurance company's investments are classified as capital assets for tax purposes, despite the fact that they generate ordinary income while held and are used to support obligations that generate deductions from ordinary income. The capital treatment of these investment assets creates significant timing and character mismatches for insurance companies, which are made worse by current law's failure to permit tax hedge qualification for insurers' business hedges of capital assets and the IRS' position that not all insurers' hedges can be classified as primarily managing risks with respect to ordinary liabilities.

Hedging Transactions. Qualification for tax hedge accounting is beneficial for several reasons. The taxpayer is entitled to adopt an accounting method that clearly reflects income through matching of the timing of income, deductions, gains and losses, in the hedging transaction and the item(s) hedged.[2] Gains and losses have ordinary character permitting a character match to ordinary liabilities.[3] In addition, tax hedges are excepted from the adverse effects of the straddle and I.R.C. § 1256 mark-to-market rules.[4]

To qualify for tax hedge treatment, a hedging transaction must (1) manage risk of price changes or currency fluctuations with respect to ordinary property, or (2) manage risk of interest rate, price changes or currency fluctuations with respect to ordinary obligations (policy liabilities).[5] Significantly, a transaction that hedges a risk relating only to a capital asset (such as an insurance company's investment assets) does not qualify for tax hedge treatment. Duration gap hedges (which relate to both capital assets and ordinary liabilities) are particularly problematic under current law because the IRS takes the position that tax hedge qualification applies only if the hedge is more closely related to ordinary liabilities than to capital assets.[6] This standard is difficult to apply because, by definition, a gap hedge relates to both assets and liabilities and closes the duration gap between the two.

A failure to qualify for tax hedge treatment can result in a character mismatch of capital losses on the hedging instrument even though any economic gain from the insurance products is ordinary. There also can be a timing mismatch because the gain or loss on the derivative is not matched to the tax recognition of the hedged item—the capital asset, the policy obligations, or both.

Straddle Rules. These mismatches can be made worse if the straddle rules apply. Straddles are offsetting positions that substantially reduce the risk of loss on interests in personal property of a type that are generally actively traded.[7] Under the general straddle rules, loss deductions are deferred to the extent of unrecognized gains in any offsetting position.[8] If the loss relates to a position in an identified straddle (i.e., any straddle that is clearly identified as such on the taxpayer's books and records before the close of the day on which the straddle is acquired), the loss is disallowed and instead the basis of each of the identified positions offsetting the loss position in the identified straddle is increased by a specified percentage of the loss.[9] These straddle rules are problematic when an insurer enters into a hedging short position that the IRS considers an offset to

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capital assets. Losses on sales of the derivative could be deferred, sometimes indefinitely in the case of a macro hedge of an entire asset portfolio.

Mark-to-Market Requirements. Failure to qualify as a tax hedge can be made even worse if current law's mark-to-market rules apply. The tax law provides that each I.R.C. §1256 contract held by a taxpayer at the end of the tax year be treated as though it were sold for its fair market value on the last business day of the year, with any resulting gain or loss taken into account.[10] Sixty percent of any gain or loss is treated as long term and the remaining 40 percent is treated as short term.[11] When the taxpayer ultimately disposes of the I.R.C. § 1256 contract, any gain or loss previously included in income as the result of marking to market must be taken into account in determining the gain or loss of the actual disposition of the asset.[12] An I.R.C. § 1256 contract includes any regulated futures or foreign currency contract, but does not include swaps. Consequently, insurers hedging capital assets with futures under current law can exacerbate the timing mismatches and distort taxable income.

The insurance industry recommended that Camp include in tax reform a provision that would designate bonds and other debt instruments held by insurers as ordinary assets for all tax purposes.

JANUARY 2013 DISCUSSION DRAFT

The January 2013 discussion draft included a proposal that would require mark-to-market and ordinary treatment for all positions in a straddle that includes any derivative to which the proposal applied, even if the positions were not otherwise marked to market (i.e., a mixed straddle).[13] This proposal would have made insurers' hedging problems even worse than under current law because it would have required mark-to-market treatment of the hedged capital assets as well as the derivatives.

To address the concerns with the derivatives proposal, the insurance industry recommended that Camp include in tax reform a provision that would designate bonds and other debt instruments held by insurers as ordinary assets for all tax purposes.[14] This solution to the problems with the derivatives proposal would have the additional benefit of addressing both the timing and character mismatches of current law, and not just the specific problems with insurers' hedges.

FEBRUARY 2014 DISCUSSION DRAFT

Hedging. The comprehensive Tax Reform Discussion Draft includes a proposal similar to the derivatives proposal in the January 2013 discussion draft. Notably, however, it now includes an explicit statement that insurance, annuity and endowment contracts issued by insurance companies are not derivatives requiring mark-to-market treatment, even if the contracts include what could be considered embedded derivatives, such as equity-indexed products. It also includes a new proposal that would expand the definition of a qualified tax hedge to include transactions involving hedges of debt instruments held by insurance companies even though the hedge is of capital assets.[15] This proposal was included in response to the concerns raised by the insurance industry with the January 2013 discussion draft's derivatives proposal.

Allowing an insurer's business asset hedges to qualify as tax hedges would address most income/deduction timing mismatches that occur under existing law and would generally prevent the derivatives proposal from exacerbating those mismatches. However, the hedging proposal could exacerbate capital asset/ordinary liability character mismatches in certain market scenarios because the sale of the underlying hedged bonds would still be treated as the sale of a capital asset. For example, in a rising interest rate environment, the sale of a portion of the bond portfolio likely results in a capital loss. Under current law, the capital loss may be offset in whole or part when the assets are hedged economically with short derivative positions (which give rise to capital gains). Under the 2014 Discussion Draft's hedging proposal, however, the derivatives would yield ordinary income, which the capital losses cannot offset. Instead, the capital losses would be deferred, and perhaps expire at the end of a five-year carryforward period, unless there is another source of capital gains (which is unlikely in a rising interest rate environment). Thus, in this scenario, the ordinary treatment of derivatives as qualified tax hedges without a corresponding ordinary treatment of assets could result in a worse mismatch, and a greater potential for the inability to deduct capital losses, than under current law.

In addition, the Discussion Draft's hedging proposal fails to address the problem of capital asset/ordinary liability character mismatches outside of the hedging context. Any comprehensive tax reform effort should also correct these mismatches. Adopting the insurance industry's suggestion to treat debt instruments held by insurance companies as ordinary assets for all purposes would solve both the character and timing mismatches that exist under current law.

The Discussion Draft also contains some technical issues for insurance companies. For example, the Discussion Draft proposes to expand current law's specific tax hedge identification rules to allow identification of a transaction as a hedging transaction for financial accounting purposes (i.e., within the meaning of generally accepted accounting principles) to constitute adequate identification for tax hedge qualification.[16] While that rule would be a significant simplification to the hedging rules for many companies in other industries, it would be inadequate for insurance companies that are required to follow statutory accounting rules. To allow insurance companies to benefit from the proposed simplification, it should be expanded to allow identifications of hedges made for statutory accounting purposes (as well as those made for financial accounting purposes) to satisfy the identification requirement for tax purposes.

Other Financial Products Changes. The Discussion Draft would require the inclusion in income of accrued market discount in the same manner as original issue discount, but would limit the accrual amount for distressed debt.[17] The Joint Committee on Taxation estimated this proposal would raise $0.9 billion, which would appear to be grossly understated as applied to the insurance industry.[18] The proposal includes two features intended to minimize the character and timing mismatches that would result from requiring a taxpayer to include market discount in ordinary income on a current basis with the possibility of recognizing a capital loss (as a result of basis increases associated with the income inclusions) in a later year when the bond is sold or otherwise disposed. First, as a rough approximation of market discount attributable to changes in market interest rates rather than doubts about a particular issuer's ability to repay the debt, the proposal would limit the required accrual to an amount determined using a discount rate equal to the greater of (i) an amount equal to the bond's yield to maturity (determined as of the date of the issuance) plus five percentage points or (ii) an amount equal to the applicable federal rate for the bond (determined at the time of acquisition) plus 10 percentage points. Second, the proposal would treat any loss that results on the sale or other disposition of a bond as an ordinary (rather than capital) loss to the extent of previously accrued market discount.

The original issue discount rules, on which the market discount proposal is based, are a set of rules designed to allow taxpayers to approximate for tax purposes the economic interest income from bonds purchased at a discount. However, the tax law already permits life insurance companies to determine their original interest discount inclusions for tax purposes using the same method that they use for statutory accounting purposes.[19] To the extent the market discount proposal is intended to apply to life insurance companies, life insurers should be permitted to use the same method that they use for statutory accounting purposes.

A separate proposal would expand the wash sale rules to apply to related-party sales, which are defined to include transactions between two corporations when one corporation owns (directly or indirectly) more than 50 percent of the other corporation.[20] This proposal does not include a provision for the carryover of basis in related-party wash sales (except when the related party is the taxpayer's spouse) and thus would appear to permanently disallow a loss on sales between affiliated corporations in the same ownership chain. Such a result would be quite harsh and is likely unintended. If this issue with the proposal is not addressed, then, for example, parent-subsidiary conventional coinsurance transactions in which depreciated assets are transferred could not occur without a tax cost because such transactions would be wash sales.

Another proposal would generally require taxpayers using the accrual method of accounting to include an item in taxable income no later than the year in which the item is included in income for financial statement purposes.[21] Similar to the wash sale proposal, this proposal is written in such a way that it likely would have unintended consequences. As one example, the proposed financial ac-

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counting/tax income matching rule appears to require that embedded derivatives that are marked-to-market for financial accounting purposes must also be marked-to-market for tax purposes. However, that result conflicts with the apparent policy set forth in the Discussion Draft's separate proposed specific exclusion of insurance products from mark-to-market treatment for embedded derivatives.[22]

The Discussion Draft also includes financial products proposals that would have a smaller impact on life insurance companies. The Discussion Draft has new rules for determining the issue price in the case of an exchange of debt instruments (including by significant modification)[23]and providing that the holder of a debt instrument generally should recognize neither gain nor loss when a significant modification occurs.[24] Other proposals would make certain clerical amendments to the rules governing the taxation of certain government obligations;[25] require that the cost basis of substantially identical securities held by a taxpayer be determined on a first-in, first-out basis;[26] provide nonrecognition treatment for most derivative transactions by a corporation with respect to its own stock;[27] require the inclusion in income of interest on newly issued private activity bonds;[28] prohibit federal tax credits for newly issued mortgage credit certificates;[29] require the inclusion in income of interest on advanced refunding bonds;[30] and generally repeal the rules relating to tax credit bonds.[31]

CONCLUSION

As it relates to financial products, the Discussion Draft is only the beginning of the legislative process. As work continues on tax reform, the life insurance industry should continue to bring to the attention of Congress not only the big issues, such as character mismatches and the significant impact of the market discount proposal, but also the technical problems, such as the limited tax hedge identification rule and the problems with related-party wash sale lost basis.

END NOTES

1 Draft Tax Reform Act of 2013 (financial products discussion draft) (Jan. 24, 2013), http://waysandmeans.house.gov/uploadedfiles/leg_text_fin.pdf.
2 Treas. Reg. § 1.446-4.
3 I.R.C. § 1221(a)(7); Treas. Reg. § 1.1221-2(a)(1).
4 I.R.C. §§ 1092(e), 1256(e).
5 I.R.C. § 1221(b)(2)(A)(i); Treas. Reg. § 1.446-4. A hedging transaction must also be clearly identified as such on the taxpayer's books and records on the day it is acquired, originated, or entered into. I.R.C. § 1221(a)(7); Treas. Reg. § 1.1221-2(f).
6 T.D. 8555 (preamble), 1994-2 C.B. 180.
7 I.R.C. § 1092(c)(1), (2).
8 I.R.C. § 1092(a)(1). Recognized gains are not deferred.
9 *Id.*
10 I.R.C. § 1256(a)(1).
11 I.R.C. § 1256(a)(3).
12 I.R.C. § 1256(a)(2).
13 Draft Tax Reform Act of 2013, § 401.
14 The American Bar Association's Section of Taxation made a similar suggestion in comments submitted to Congress, Treasury and the IRS on May 21, 2012, offering options for tax reform in the provisions of the Internal Revenue Code affecting insurers.
15 Draft Tax Reform Act of 2014, § 3402(a)(1). This proposal would treat the debt instruments as ordinary assets for purposes of determining tax hedge qualification only; they would continue to be treated as capital assets for other purposes of the Internal Revenue Code.
16 *Id.*
17 *Id.* § 3411.
18 Joint Committee on *Taxation, Estimated Revenue Effects of the "Tax Reform Act of 2014"* (JCX-20-14), at 8 (Feb. 26, 2014).
19 I.R.C. § 811(b).
20 Draft Tax Reform Act of 2014, § 3422.
21 *Id.* § 3303.
22 *Id.* § 3401 (adding new I.R.C. § 486(c)(2)).
23 *Id.* § 3412(a)(1).
24 *Id.* § 3412(b)(1).
25 *Id.* § 3414.
26 *Id.* § 3421.
27 *Id.* § 3423.
28 *Id.* § 3431.
29 *Id.* § 3432.
30 *Id.* § 3433.
31 *Id.* § 3434.