

**U.S. House of Representatives Committee on Ways and Means
Tax Reform Working Group on Financial Services
Comments of the Investment Company Institute on the
Discussion Draft Regarding Taxation of Financial Products**

April 15, 2013

The Investment Company Institute¹ appreciates this opportunity to comment on fundamental tax reform. We applaud the Committee and Chairman Camp for tackling an issue as complex, and yet as important, as financial products taxation. We also commend the Committee and the Chairman for releasing proposals in discussion draft form and soliciting public feedback. Given the Internal Revenue Code's² complexity, especially in the area of financial products, facilitating an open discussion will help ensure that any changes to the tax laws both reflect sound tax policy and are workable.

We understand that the Committee intends for these proposals to be included in a comprehensive tax reform package that will lower federal income tax rates substantially. Our comments on the discussion draft reflect this understanding.

The two discussion draft proposals of greatest importance to our industry are the primary focus of our comments.

- The first proposal would mark all derivatives to market. While more uniform taxation of derivatives generally would benefit both funds and their investors, the current draft raises several concerns (including, in isolation, a generally higher tax burden on investors). If a mark-to-market approach for derivatives is advanced, we suggest changes to several provisions, including the broad scope of the definition of “derivative,” the decision to treat marked gains and losses as ordinary, and the application of the straddle rules.
- The second proposal would require investors to compute gain or loss using the average cost basis method. While forcing all investors onto a single basis methodology might appear to “simplify” gain/loss calculations, the proposal raises significant complexities

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$14.7 trillion and serve over 90 million shareholders.

² All references to “the Code,” unless indicated otherwise, are to the Internal Revenue Code.

and would not improve tax compliance. Because of these concerns, discussed in detail below, we urge that the mandatory average cost proposal be dropped.

Our comments also discuss the impact on funds of the proposals to require current accrual of market discount, to extend the wash sale rule to certain related parties, and to change the determination of issue price in connection with a debt modification.

Derivatives and the Mutual Fund Industry

Regulated investment companies (“RICs”) and other funds registered under the Investment Company Act of 1940 provide average retail investors with professionally-managed, diversified portfolios that these individuals cannot replicate on their own. These individuals also benefit from the investment management tools that funds are designed to utilize.

Funds use derivatives to advance successful long-term non-tax investment strategies. Various derivatives are used for various purposes. For instance, in the fixed income context, derivatives are used to manage a fund’s exposure to things such as credit risk, inflation, interest rates, and currency movements. A bond fund’s duration or effective interest rate also may be varied through derivatives, including when bonds available in the market do not match precisely the fund’s investment objectives. To achieve these results, funds use, among others, futures contracts on bonds and Treasuries, forward contracts on currencies, interest rate swaps, credit default swaps, sales and repurchase agreements (“repos”), and convertible debt.³ While the fund industry most commonly uses derivatives in fixed income funds, derivatives also may be used in equity portfolios to achieve specific investment goals. For example, funds may use derivatives to gain exposure to foreign markets in which it may be difficult or expensive to hold the securities directly.

In sum, derivatives permit funds to fine tune their portfolios to better achieve the funds’ investment objectives, while reducing transaction costs and risks. Their use benefits the mutual fund shareholder.

Mark-to-Market of Derivatives

Funds and their investors generally would benefit from more uniform tax treatment of derivatives. This area of the tax law is particularly complex. Because the tax laws have not kept pace with financial product development, new financial products typically must be pigeon-holed into existing tax regimes that were not designed for them. Transactions with similar economic results, consequently, can be subject to rules providing very different tax treatment. The lack of precise and cohesive rules also may lead to inconsistent treatment among reasonable and compliant taxpayers.

Tax certainty is particularly important to RICs because they are subject to stringent qualification and distribution requirements under Subchapter M of the Code; these requirements

³ Although repos and convertible debt generally are not considered derivatives, we include them here because repos arguably are included in the definition of derivatives, and the discussion draft proposals explicitly address convertible debt.

include asset diversification and income tests that funds must meet to qualify as RICs. Funds also must distribute substantially all of their income each year to avoid income and excise taxes at the entity level. The uncertain tax treatment of derivatives can make this tax compliance particularly difficult.

The lack of clear and cohesive rules for the taxation of derivatives also complicates accounting compliance for RICs under the rules of the Securities and Exchange Commission (the “SEC”). Under SEC rules, RICs must follow the standards set by the Financial Accounting Standards Board (“FASB”). FASB’s Accounting Standards Codification Topic 740 (“FASB ASC 740”, which formerly was codified as, and is more generally known as, “FIN 48”), has increased the resources that funds must spend to support accounting for the tax effects of their investments in derivatives. Working with their outside legal advisors and accounting firms, funds must document that their tax treatment of derivatives will be sustained upon examination, based on a more-likely-than-not standard. Meeting the FASB standard would be considerably easier if the rules for taxing derivatives were more clear.

In addition to tax and accounting compliance, uncertainties regarding the tax treatment of particular products can create competitive disadvantages. Funds may wish to enter into certain products or transactions to give their investors exposure to a specific type of security or asset. Whenever the tax treatment of a product or transaction is unsettled, different tax lawyers may disagree about the proper treatment, or at least about their level of comfort with respect to that treatment. Thus, competing funds may receive different opinions about the same financial product, leading one to use it while the other does not. Similarly, competing funds may evaluate differently the degree of uncertainty regarding a product; these differences likewise might lead one but not the other to acquire a certain product or engage in a certain transaction. Funds should not be disadvantaged based on the law firm they use or their differing evaluations of legal uncertainty. Providing a uniform regime for the taxation of financial products would help eliminate these concerns.

Finally, more uniform taxation of derivatives removes tax considerations, when choosing between derivatives, from a fund’s investment decisions. Today, different products or transactions with the same or similar economic results can be taxed entirely differently, with respect to both timing and character. Funds take these differences into account when making investment decisions. Eliminating tax considerations from these decisions would allow funds to focus more intently on the economics of a product or transaction. Importantly, however, the discussion draft creates additional tax differences between derivatives and the underlying assets; these differences, as discussed below, still would affect investment decisions.

For these reasons, the fund industry agrees that more uniform taxation of derivatives is warranted and long overdue. We understand that a broad mark-to-market approach may be appealing because, at least theoretically, it appears relatively simple to apply; many derivatives, for example, already are marked to market for tax and/or book purposes. Many practical issues suggest, however, that a mark-to-market regime may not be the most appropriate tax treatment for all derivatives. Consequently, we urge the Committee, as it moves forward with tax reform, to consider other ideas as well.

Our three primary recommendations for any mark-to-market proposal that is advanced are discussed below. First, the definition of “derivative” should be narrowed. Only those products and transactions for which mark-to-market is appropriate should be covered. Second, ordinary treatment of gains and losses could create a character mismatch between the derivative and the underlying securities. This could be avoided by applying to the year-end marks of the derivative the same character that would apply to the underlying asset. Finally, the straddle rules, if incorporated into a new regime, should be modified. An “investment hedge” approach, modeled on the current regime for business hedges, would clarify and simplify application of these rules to funds.

Definition of Derivative

The definition of “derivative” in the discussion draft is quite broad. This broad definition, we understand, was designed to generate discussion about what types of instruments and transactions should be covered by the proposal. We recommend, as discussed below, that the definition be narrowed to exclude certain instruments and transactions.

Our recommendation recognizes that some line-drawing will be necessary. We believe the Committee acknowledges this viewpoint in its decision to distinguish between derivatives, on the one hand, and their underlying assets (and potentially economically equivalent securities), on the other. Whenever lines are drawn, however, such as between stocks and derivatives or between different derivatives, tax planning opportunities will arise. The benefit of a more uniform regime, however, very well may outweigh these concerns.

The proposal’s broad definition of “derivative” is expansive enough to encompass a number of instruments and transactions that are not typically thought of as derivatives. We believe the definition should be narrowed to exclude such instruments and transactions, which are frequently used both by funds and by ordinary investors. These include securities loans, repos, annuity contracts, and American Depository Receipts (“ADRs”), but also extend to interests in partnerships that hold stocks and securities (which are used for portfolio management reasons by fund complexes in master-feeder or fund-of-funds structures), or even stock purchase agreements. We urge that the definition of “derivative” be narrowed, or that these and similar instruments and transactions be excluded. We would welcome an opportunity to work with the Committee to identify instruments and transactions that should fall outside the definition of “derivative.”

We also recommend exempting embedded derivatives, such as the option component in a convertible bond, from a mark-to-market regime. While many funds currently invest in convertible bonds, their systems do not bifurcate a bond into its debt and option components. Even if such a system could be built, the associated administrability concerns most likely would diminish the industry’s interest in purchasing convertible debt. In addition, it is likely that different firms would value the debt and option components differently, leading to inconsistencies with respect to the same instrument. As a result, it is difficult to see how the Internal Revenue Service (the “IRS”) could fairly and efficiently administer the proposed rules regarding embedded derivatives.

Finally, we note that the current-law rules for some derivatives are clear. Whether the goal of uniformity warrants changing these rules is not so clear. A good example is the current tax treatment of options, which generally are taxed on a realization basis and result in capital gains and losses. Most options tend to be short term, and the policy concerns regarding deferral that are raised by long-term derivatives are not present.

Of course, a uniform rule for the tax treatment of derivatives, such as a mark-to-market regime, would provide much needed clarity with respect to other derivatives. A prime example is credit default swaps, for which the correct treatment currently is unclear.

Ordinary Treatment

The derivatives proposal would treat any mark-to-market gains or losses as ordinary. We urge the Committee instead to treat any mark-to-market gains or losses as having the same character as the underlying security.⁴

Providing consistent tax treatment between the character of a derivative and its underlying security is more appropriate, particularly given that most, including stocks and bonds, are capital assets. There are no obvious tax policy reasons why the character of their gains or losses should be different from that of the underlying assets. Consistent treatment, which would mandate capital treatment for most derivatives, also would resolve several RIC-specific problems that would arise if mark-to-market gains and losses all were treated as ordinary.

The mark-to-market proposal in most cases would create significant disparities between the treatment of derivatives and their underlying assets. The difference in character would eliminate some planning opportunities but create a number of others. One complaint about the current state of the taxation of financial products is that instruments or transactions that are economically similar can have materially different tax results. The discussion draft would partially address this problem by treating all derivatives in the same manner, but it still would allow for different tax treatment of stocks and bonds, on one hand, and economically equivalent derivatives, on the other. Thus, a taxpayer that wants capital treatment would invest directly in stock, but an investor who prefers ordinary income could invest in a total return swap (or some other derivative or combination of derivatives) that provides the same economic exposure as direct ownership. We thus believe that tying the tax treatment of derivatives to the underlying security would be more appropriate and would limit these planning opportunities.⁵

Ordinary income treatment would create unique difficulties for RICs. One such difficulty arises because, under current law, funds cannot carry forward net operating losses (“NOLs”). As most

⁴ In most cases, the assets underlying derivatives are capital assets. There are some assets, however, that are ordinary, such as currency. Thus, although mark-to-market gains and losses from most derivatives should be treated as capital, it would be appropriate to treat mark-to-market gains from derivatives such as currency forwards as ordinary.

⁵ Whether any gains or losses are long-term or short-term similarly should be tied to the length of the derivative contract. If a taxpayer holds a derivative for more than one year, any marks after the first year should be treated as long-term. This would be more consistent with the tax treatment of the taxpayer if it held the underlying asset directly.

funds today typically have ordinary income in excess of their ordinary losses and expenses, the absence of carryforward treatment has not been particularly problematic. If mark-to-market losses were ordinary, however, funds would be more likely to experience NOLs more frequently and in greater dollar amounts. Funds therefore would need the ability to carry forward NOLs indefinitely to prevent fund investors from being unfairly “whipsawed.”⁶ This “whipsaw” treatment would occur if a fund had net mark-to-market gains in some years and net mark-to-market losses in other years. Assume, for example, a fund had \$100 of ordinary income in year one, a \$100 of ordinary loss in year two, and another \$100 of ordinary income in year three. Over this period, the fund would need to distribute \$200 of taxable income to its shareholders even though its economic income was only \$100. The ability to carry forward NOLs – thereby allowing the fund to reduce its year three income by the year two loss – would address this unfairness.

Mutual funds also would be subject to an additional whipsaw in that they would not be able to offset capital losses on their portfolio securities (such as stocks or bonds) with ordinary gains on their derivatives. This would be true even when both types of investments were part of a coordinated approach for maximizing shareholder value. As discussed above, derivatives are a fundamental part of how RICs build their portfolios. If losses on portfolio securities could not be offset against gains on the RIC’s derivatives, however, average investors would see a significant change in how their RIC investments are taxed. To remain compliant with Subchapter M distribution requirements, funds could be forced to distribute additional amounts resulting from the ordinary gains from derivatives. Gains from derivatives may be offset by losses in the portfolio under current law, but the character mismatch created by the discussion draft proposal would prevent this.

Straddle Rules

The straddle rules, if incorporated into a new regime, should be clarified and simplified. There is a great deal of uncertainty under current law as to whether a straddle exists and, if so, which positions are part of the straddle. These uncertainties cause the straddle rules to be applied inconsistently.

Use of the straddle rules to determine when non-derivatives, such as stocks and bonds, are subject to the proposed mark-to-market regime would place additional pressure on the proper identification of straddle positions. If the character of the mark is ordinary, there would be a significant difference in the tax consequences if a stock or bond were in a mixed straddle or not. This change of tax consequences would be less of an issue if the mark-to-market character were capital, but it still would require the stock or bond that is part of the mixed straddle to be marked to market annually and perhaps more frequently (*i.e.*, when a taxpayer legs into or out of a mixed straddle).

Moreover, the proposal would require the full amount of unrealized gain in an appreciated position to be recognized upon legging into a straddle, even in cases that would not constitute a

⁶ Bond funds today receive fairly predictable and recurring amounts of interest income from their portfolio holdings. Bond fund investors, consequently, expect regular (generally monthly) and fairly constant dividends from these funds. Offsetting ordinary losses from derivatives against this interest income would cause distributions to vary and/or change the tax character of the distributions from taxable to return of capital. Investor expectations would be upset in either situation.

constructive sale (*i.e.*, where there remains a substantial risk of loss or opportunity for gain in the underlying provision). This is a significant departure from current law, and it is not clear that such a change is warranted.

Any clarification of the straddle rules should address so-called “unbalanced straddles” which arise when a derivative is part of a straddle with some but not all of an underlying position. Any clarification also should preserve taxpayers’ ability to identify the positions in a straddle. The draft proposal, which would repeal the identification option, would exacerbate the existing uncertainty in the straddle area.

Our concerns regarding the straddle rules could be ameliorated, to a significant extent, by a new investment hedge exception comparable to that provided for business hedges. RICs and other investors often use derivatives to hedge risks on individual positions or on their portfolios as a whole. This type of investment or portfolio hedging is not eligible for the business hedging rules of section 1221 and therefore is not exempt from the mark-to-market proposal.

These investment or portfolio hedges, which are not entered into for tax reasons, could have negative tax consequences for the funds and their investors under the discussion draft proposal. For example, international bond funds typically enter into forward contracts on currencies to hedge the risks of movements in exchange rates. If a fund concluded that these forwards should be treated as part of mixed straddles with the fund’s debt holdings, a fund could be required to recognize unrealized ordinary income each year on the entire portfolio. Similarly, municipal bond funds often use consumer price index (“CPI”) swaps to hedge inflation risk on their portfolios. If a CPI swap is considered part of a mixed straddle, the mark-to-market treatment could create taxable ordinary income with respect to the municipal bonds, thus converting tax-exempt income into taxable income.⁷

We encourage the Committee to explore an investment hedging regime that moves away from the punitive nature of the straddle rules and towards the “clear reflection of income” approach applicable to business hedges. Under such a regime, the character of derivatives that are used to hedge other investments generally would match the character of those other investments. Gains or losses on the derivative would be deferred until gains or losses are recognized on the hedged assets. Similarly, gains on appreciated positions would not be triggered merely because a taxpayer entered into a derivative to hedge the position. This type of regime would more clearly reflect the economics of derivatives used to hedge investment or portfolio risk and could resolve many of the industry’s concerns with the current mark-to-market proposal.

In addition, we believe the final approach to the straddle rules under the derivatives proposal should retain the exception for qualified covered call options (“QCCOs”) under section 1092(c)(4). QCCOs are commonly entered into by funds and retail investors to increase the return on a stock by writing an at- or out-of-the-money call option. Writing a QCCO does not substantially reduce a fund’s

⁷ The draft proposal treats as ordinary income all income from a non-derivative that is part of a straddle that includes a derivative. This approach raises the concern that the tax-exempt interest on a municipal bond that is part of a straddle with a derivative would be treated as taxable ordinary income.

risk of loss on the underlying stock. If the QCCO exception were repealed, and covered calls were subjected to the proposed mixed straddle rules, funds might simply stop writing calls on appreciated positions rather than recognizing the built-in gain in the covering position and exposing it to mark to market ordinary treatment. Suspending these activities, which already are subject to well-defined statutory and regulatory standards, ultimately would harm both fund investors, in the form of lower returns, and the securities markets as a whole, in the form of decreased liquidity and broader bid-ask spreads.

Other Issues

Wash sale rules and mixed straddles. The mark-to-market proposal does not include an exception to the wash sale rules for mark-to-market losses on a non-derivative that is part of a mixed straddle. Thus, for example, if a taxpayer has a mixed straddle and must recognize a mark-to-market loss on a stock that is part of that straddle, that loss could be disallowed (under the wash sale rules) if the taxpayer purchases substantially identical stock within the 60-day period. The exception to the wash sale rules for derivatives that are marked to market also should apply to non-derivatives that are marked to market under the proposed mixed straddle rules.

Impact on the average retail investor. Finally, we understand that one goal of the mark-to-market proposal was not to affect the average retail investor. Because mutual funds are the investment vehicle of choice for so many average retail investors, the discussion draft absolutely will affect them. The impact is greater because mutual funds are required to distribute their income and gains, even if the resulting taxable income is attributable to unrealized gains on instruments that are marked to market. If that income is taxed at ordinary income rates, which includes short-term capital gains, it will be taxed at higher rates than if it is long-term capital gain. Moreover, the character mismatches created by the proposal, in combination with RICs' distribution requirements, will create inefficiencies at the fund level that will impact fund shareholders. Most notably, funds may have to sell assets that they otherwise would continue to hold, but for the need to distribute income attributable to mark-to-market gains. The sale of these assets in turn would result in additional capital gain or loss to the fund, affecting the shareholders' investment. Any proposal that affects the taxation of a fund's investments ultimately will affect the fund shareholders.

Mandatory Average Cost

We strongly urge the Committee to drop the proposal to require all investors to compute gain or loss using the average cost basis method. This proposed change to current law would provide little, if any, benefit. Substantial burdens, however, would be imposed on funds, their shareholders, reporting brokers, and others. Importantly, average cost basis is not nearly as simple to apply as it may appear, will result in additional "locked-in" investment, and is not appropriate for all taxpayers.

Mutual funds view the average cost proposal through two lenses. The first is as a reporting agent subject to the information reporting rules under section 6045. Mutual funds currently provide cost basis information for certain accounts to their shareholders and the IRS. In this role, we consider whether a change in current law benefits our shareholders, and whether any such benefits are

outweighed by the costs necessary to implement that change. Mutual funds also view the proposal as holders of securities that would be required to apply average cost to their own portfolios. Our primary concern in this role is determining how to apply average cost to a large, actively traded portfolio.

The mutual fund industry has substantial experience with reporting cost basis to investors. Some mutual funds began providing cost basis information to their shareholders over forty years ago. Most of the industry began providing this information voluntarily about twenty years ago. For the past five years, because of federal legislation mandating cost basis reporting, funds and brokers have spent considerable time and resources addressing cost basis reporting requirements. The expended effort has included (1) revising cost basis reporting systems to, among other things, accommodate shareholder elections to choose any available cost basis method and (2) educating shareholders about the methods available to them. Changing the rules now will create additional confusion for shareholders and negate much of the work done already. Investors should retain their ability to choose their cost basis methodology for all securities.

The industry has considerably more experience with calculating gains and losses on fund portfolios, which it has done since the industry began in the 1920s. These calculations, however, used some form of specific identification of lots, not average cost.⁸ Because of the intractable problems of applying average cost to calculate gains or losses on a fund's portfolio, while various basis adjustments continue to be made (as they must) on a lot-by-lot basis, we also strongly urge that this proposal not apply to fund portfolios.

We understand that one argument for average cost is that securities are fungible; under this theory, average cost purportedly reflects more clearly the taxpayer's financial position. While this statement may be true in an economic sense, it certainly is not true from a tax perspective. All tax attributes in the Code, such as holding periods and adjustments for wash sales and market discount, are calculated at the lot level. The lots therefore are not fungible for tax purposes; different lots may have very different tax attributes associated with them.

Moreover, investors certainly do not view their lots as fungible, as different lots may have been purchased at different times for different amounts. The fact that an investor paid \$100 per share for one lot and \$200 per share for another has economic significance to that investor, especially given that the sale of different lots may have vastly different tax consequences. It has long been a fixture of our tax system that taxpayers are able to control the timing of their gains and losses by choosing which lots to sell. It is not clear why this tenet of our tax laws should be replaced by such a fundamental change.

⁸ The average cost method only is available for RIC shares and, after 2012, other stocks acquired in dividend reinvestment plans. Thus, it is available to RICs only with respect to any shares in other RICs that funds may hold. Further, use of average cost is elective. Given the complexities that arise from applying average cost to a diverse and actively traded portfolio, funds would not use average cost even if it were available.

Application to Fund Shareholders

As “brokers” that are required to report cost basis information under section 6045,⁹ the fund industry does not believe that limiting taxpayers to only average cost advances compliance or simplification. In the absence of these two goals, it is not clear what purpose would be served by changing current law.

Funds and brokers already have systems in place to calculate cost basis using any method that a shareholder chooses, as required by law. The purpose of mandatory cost basis reporting was to improve tax compliance by individuals with respect to capital gains and losses. Beginning in 2012 for mutual fund shares, and in 2011 for all other equities, funds and brokers have been calculating and reporting cost basis to many of their customers and to the IRS. Therefore, any compliance concerns were addressed in 2008 when mandatory cost basis reporting was enacted.

Requiring average cost will not necessarily simplify basis calculations, even though taxpayers would be limited to a single method. Simplification would not occur because, among other things, the Code’s tax adjustments are applied at the individual lot level. Specific identification, or some form thereof, is simple in that the basis of securities sold depends only upon the acquisition price and any tax adjustments that apply to that specific lot. With average cost, any tax adjustment that affects a single lot affects the cost basis of the entire position. Thus, instead of performing simply one step (any adjustment to acquisition cost) to calculate cost basis, two steps (any adjustment to acquisition cost plus averaging) would be required. Although this extra step sounds relatively simple in the abstract, it sometimes can be difficult even for “simple” investments. It becomes increasingly difficult the larger a position becomes and the more transactions that have occurred with respect to that position.¹⁰

Another problem with the average cost method is that it requires perfect information with respect to all the shares in the position to properly calculate the average cost. Any incorrect or unknown information with respect to some of the shares calls into question the average cost for the entire position; thus, any shares for which there is imperfect or incomplete information must be walled off and held in a separate account from the rest of the shares. A good example of this is shares that are gifted at a loss (*i.e.*, the fair market value at the time of the gift is less than the donor’s basis).¹¹ Because

⁹ Mutual funds are considered “brokers” under the tax laws for purposes of information reporting. The definition of “broker” includes any person that, in the ordinary course of a trade or business, stands ready to effect sales to be made by others. Treas. Reg. § 1.6045-1(a)(1).

¹⁰ For example, average cost calculations become more difficult if the taxpayer has purchased multiple lots over several dates, including through dividend reinvestment periods. Adjustments due to wash sales, returns of capital, or corporate actions must be applied to individual lots, rather than the entire average cost, to correctly reflect the cost of the affected lots. Transfers in or out of an account also complicate the average cost calculation. These transfers can occur as the result of gifts or inheritances, transfers for value, or simply because a shareholder wishes to transfer some shares to a different broker.

¹¹ Generally, the recipient of gifted shares takes the basis of the shares in the hand of the donor. This rule does not apply, however, if the shares are gifted at a loss. In those cases, the basis of the gifted shares depends upon the fair market value upon a subsequent sale by the donee. Section 1015(a). The donee’s basis for determining gain or loss generally is the basis of the shares in the hands of the donor; however, if the fair market value of the shares at the time of the subsequent sale is

the basis of the gifted shares in these cases depends upon the fair market value upon a subsequent sale, a taxpayer cannot use the average cost method for shares that are gifted at a loss.¹² Thus, the shares that were gifted at a loss cannot be averaged together with any other identical shares held by the taxpayer and must be tracked separately.

Average cost similarly will not simplify tax reporting. Mutual funds have spent considerable resources educating their shareholders about the cost basis methods available and the resulting changes to their tax forms. Anecdotal evidence suggests that the cost basis reporting process has gone relatively smoothly for 2012, which was the first year that cost basis reporting applied to fund shares. If the law is changed to permit only average cost for all securities, funds and brokers will have to engage in additional customer communications and education to explain the new law and how it affects the customers' existing and future securities. Rather than simplifying the current process, mandating average cost will only add additional complications.

Importantly, additional complexities will arise from the need for any change, if it is to be implemented properly, to apply prospectively only. Prospective application means that, for some extended time period, the information reporting and tax forms will be even longer and more confusing than they are currently; additional categories of long and short-term gains and losses will be necessary to accommodate pre- and post-effective date shares.¹³ These additional categories cannot be dropped from the forms until the IRS is certain that all pre-effective date shares have been sold or transferred. It will be decades before this would happen. It is not clear that making this change for the purpose of simplification in maybe fifty years is worth the time and effort today.

Further, permitting only average cost will not reduce a fund's or broker's recordkeeping or data retention. Even if a shareholder today were required to use average cost, the fund or broker would have to keep all of the individual lot history for an extended period of time. This is true today, if a shareholder chooses average cost under current law. Lot-specific information is necessary in case any corrections or adjustments must be made, such as adjustments to basis due to a corporate action or return of capital. These adjustments must be made at the individual lot level because only shares held on the applicable should be adjusted. Any such change requires the fund or broker to correct the basis for an individual lot before recalculating the average cost.

less than the donor's basis, the basis for determining the donee's loss is the fair market value at the time of the gift. Treas. Reg. § 1.1015.1(a)(1).

¹² Treas. Reg. § 1.1012-1(e)(8)(i). A taxpayer may use average cost for shares that are gifted at a loss only if the taxpayer provides a written statement indicating that he or she agrees to take the fair market value at the time of the gift as the basis of the gifted shares. Treas. Reg. § 1.1012-1(e)(8)(ii).

¹³ As discussed below, the substitute Forms 1099-B had to be expanded to accommodate the new categories of "covered" (those securities subject to mandatory cost basis reporting) and "noncovered" securities (those not subject to mandatory cost basis reporting). Mandatory cost basis reporting also required the IRS to add an additional form, Form 8949, to the IRS Form 1040, as an attachment to the Schedule D, to permit taxpayers to report these various categories of capital transactions. Mandating average cost will not simplify these forms but likely will complicate them further, depending on the effective date and transition rules for the proposal.

Finally, it is important to note that, although average cost currently is available for mutual fund shares, it is not a permissible method for stock (other than stock acquired through a dividend reinvestment program, or “DRP”) or for debt. Therefore, brokers have not built systems to calculate and report average cost with respect to all stock and debt. Significant additional expenditures of resources, beyond those already spent, will be required to change methods yet again. Also, as discussed in more detail below, applying average cost to debt is significantly more difficult than applying it to stock. Because average cost currently is not available for debt, current accounting systems for debt cannot accommodate this method; they will have to be built from scratch and must address the issues discussed below.

Application to Fund Portfolios

Mandatory average cost would create numerous issues for funds as holders of securities. Although securities may be fungible from an economic standpoint, as noted above, they are not fungible for tax purposes. All tax adjustments are made at the individual lot level, and tax attributes (including holding period) attach to the individual lots. Calculating these individual adjustments and their effect on other identical securities is especially onerous for a large, actively traded portfolio.

Numerous tax adjustments must be made by funds, some as frequently as daily, to the cost basis of their portfolio securities; these adjustments include amortization/accrual of market discount/premium, accrual of original issue discount, wash sales, and passive foreign investment company (“PFIC”) inclusions. Every such adjustment would change the average cost of each security each time the adjustment were made, as frequently as daily. Cost basis would be extremely difficult to audit, as adjustment errors quickly would be buried under subsequent adjustments intertwined with repeated average basis calculations. Baking a cake offers a simple analogy: Once the ingredients have been mixed together, they cannot be separated out to determine if you added too much or too little of any single ingredient. While this analogy may seem hyperbolic, sorting out individual adjustments would be extremely difficult for a fund; fund portfolios typically will have scores of separate securities, multiple lots (sometimes hundreds) of each security, and several thousand transactions each year.

The greatest difficulty occurs when part of a holding is sold (*i.e.*, a partial sale) in determining how that sale affects the remaining lots in the portfolio and the tax adjustments that will occur after the sale. Currently, when the fund sells a particular lot, the sale of that lot does not affect the future calculation of tax adjustments to the remaining lots. The proposal as drafted apparently would change this treatment.

Application of average cost to debt is especially difficult. Under current law, tax adjustments such as accrual of market discount and amortization of premium are computed on a lot-by-lot basis. The discussion draft does not change this; thus it is unclear how the average cost proposal should be coordinated with these other provisions.

We believe that there are at least two possible approaches, under the proposal as written, for computing these various tax adjustments in an average cost world. The first approach would continue

to apply them on a lot-by-lot basis.¹⁴ For purposes of a sale, however, the holder would use the average cost of the lots to determine any gain or loss. Funds, therefore, would need to keep two sets of books and records for their portfolios: One for tax adjustments (based on the tax lot cost) and another for sales (based on the average cost). It is not clear that a change from current law warrants this additional work.

Aside from the additional recordkeeping burdens, difficulties arise under this first approach when a partial sale has occurred. Under this approach, funds would continue to accrue market discount or amortize premium, for example, on the remaining lots on a lot-by-lot basis.¹⁵ The issue is that the average cost used for the partial sale will have taken into account the premium or discount on the retained lots, to determine the average cost of the position. Thus, premium or discount on the retained lots in effect would be double counted as the fund continues to accrue discount or amortize premium on a lot-by-lot basis following the partial sale. There would be a benefit or detriment to the fund, as this premium or discount is taken into account.¹⁶ This would be a timing difference as the fund would have to amortize or accrue the same amounts for purposes of computing the average cost, which would be used for computing gain or loss when the lots are sold or the bond matures. Again, these calculations would require funds to keep two sets of books and records with respect to the bonds in their portfolio.

The second approach would use the average cost of the entire position for purposes of accrual and amortization.¹⁷ When new lots are purchased, the premium and market discount calculations for the existing lots would be reset to the new average cost of the overall position, thus changing the amount of discount or premium on those lots.¹⁸ The benefit of this approach is that funds would not have to keep two sets of books and records. The difficulty is that fund accounting systems currently cannot handle such a change. All tax adjustments are accounted for on a lot-by-lot basis, and the systems would not be able to change this amount of discount or premium, much less switch from one to

¹⁴ This assumes that section 171(b)(1), which provides that the basis used to determine the amount of amortizable bond premium is the basis that would be used to measure the loss on a bond's sale, would not apply if gain and loss were calculated under the average cost method. Different complexities would arise if section 171(b)(1) applied.

¹⁵ Under current law, a shareholder must deplete its shares on a FIFO basis when using average cost, for holding period purposes. Presumably the same rule would apply under a mandatory average cost regime, both for holding period purposes and for other tax attributes attached to specific tax lots.

¹⁶ This double counting would result in a benefit for the taxpayer with respect to amortization of premium and a detriment with respect to market discount.

¹⁷ Note that this post-acquisition change in discount and premium would be a departure from current law. Under §1278(b)(2), market discount is determined by reference to the taxpayer's basis in the bond immediately after acquisition. Similarly, Treas. Reg. § 1.171-1(d) provides that bond premium is the excess of the holder's basis in the bond *immediately after its acquisition* over the sum of all amounts payable on the bond after the acquisition date (other than qualified stated interest).

¹⁸ Alternatively, the amounts of discount and premium on the remaining lots could be reset to the average cost only after a partial sale. Up until a partial sale, discount and premium would be calculated on a lot-by-lot basis. After the sale, discount and premium on the remaining lots would be reset to the average cost. Any further amounts of discount or premium similarly would need to be based on the average cost to prevent double counting.

the other. These adjustments would need to be done manually unless and until new systems are developed, at significant cost. Manual adjustments could lead to substantial risk of error.

Example: Fund purchases 2 lots of Bond ABC.

<u>Purchase Date</u>	<u>Issue Price</u>	<u>Purchase Price</u>	<u>Discount</u>	<u>Premium</u>	<u>Average Cost</u>
Jan. 1, 2014	100	97	3		97
July 1, 2014	100	103		(3)	100

On July 2, 2014, Fund sells Lot 1 (assuming the FIFO rule still applies) for \$100. For simplicity, we have ignored any interim accretion or amortization. Because the average cost of Bond ABC is \$100, Fund would recognize no gain or loss.

Under the first approach, Fund would continue to amortize the \$3 of premium over the life of Lot 2 of the bond, down to the issue price of \$100. This \$3 of premium essentially would be double counted as it was included in the average basis of the sold tax lot. This double counting would be a timing benefit to the Fund rather than a permanent benefit because the Fund also would amortize down the average cost of \$100 to \$97 and would recognize \$3 of gain at maturity. If Fund later buys Lot 3, the acquisition cost of that lot would be averaged with the amortized average cost of Lot 2 to determine the new average cost, but it would not affect the on-going amortization of premium on Lot 2.

Under the second approach, assume that Fund has accreted \$0.50 of discount on Lot 1 as of July 1, 2014, resulting in a basis of \$97.50. When it purchases Lot 2, the average cost becomes \$100.25 (the average of \$97.50 and \$103). Fund would then reset the amounts used for computing discount and premium on Lots 1 and 2 to the average cost. Because the issue price for Bond ABC is \$100, both lots would now have premium of \$0.25. This means that Lot 1 has switched from having discount to premium. When Fund sells Lot 1 for \$100, it would have \$0.25 of loss on the sale. Fund would continue to amortize the \$0.25 of premium on Lot 2. If Fund later purchases an additional lot of Bond ABC, the amortized cost of Lot 2 would have to be averaged together with the acquisition cost of Lot 3, and any premium or discount would again be reset to the average cost.

Complications would arise as well, albeit perhaps to a lesser extent, when applying average cost to stock. One such complexity would arise, for example, if a fund holds several lots of stock of a foreign corporation that is a PFIC for U.S. tax purposes. If the fund sells some portion of its position, it will have to determine how any unreversed PFIC inclusions under section 1296 are to be computed on the remaining shares.

One possible approach to this problem would be to require the taxpayer to assume that a pro rata portion of each lot (and the accompanying tax adjustments) has been sold. Another approach

would be to provide that all tax adjustments must be made at the security, rather than the individual lot, level; this approach, however, would result in issues similar to those raised by the second approach above.¹⁹ There are numerous provisions in the Code, in addition to the ones discussed here, that can affect the basis of securities. Any proposal to require average cost thus must address how these adjustments are applied with respect to average cost calculations if a partial sale occurs.

Application of the mark-to-market proposal for mixed straddles would create additional complications for mandatory average cost basis calculations. Those lots that are part of a straddle must be separated from those lots that are not part of the straddle; otherwise, using the average cost for all of the lots (which would change if additional lots were acquired) would upset the calculation of gain or loss with respect to the lots that are part of the straddle, and the determination of which of those amounts are ordinary or capital. This issue would arise if some but not all lots of a security are part of a straddle, or if all lots of a security are part of a straddle, and then the investor acquires additional shares that are not part of the straddle. When the taxpayer legs out of the straddle, the lots that were part of the straddle would be added back to the average cost calculation of those lots that were not part of the straddle. This movement would affect the average cost basis of the other shares.

Example: Fund has two lots of the same security. 100 shares in Lot 1 were purchased for \$10 per share; 100 shares of Lot 2 were purchased for \$12 per share. The average cost thus is \$11 per share. Fund enters into a mixed straddle that includes the 100 shares of Lot 1. The value of the shares when Fund legs in to the straddle is \$14 per share. Because the shares have appreciated, the position is treated as sold at that time. Fund thus recognizes \$3 of capital gain per share when it legs into the straddle. The basis of Lot 1 is now \$14 per share. After Lot 1 becomes part of the straddle and before the next year-end, Fund purchases an additional lot of 100 shares, Lot 3, for \$15 per share. At year-end, the value of the shares is \$16 per share.

If Lot 1 were taken out of the average cost calculation when Fund legs into the straddle, Fund would have 200 shares with an average cost of \$13 per share (100 shares in Lot 2 at \$11 per share plus 100 shares in Lot 3 at \$15 per share) after the purchase of Lot 3. In addition, Fund would have 100 shares of Lot 1 that are part of the straddle. The basis of Lot 1 when Fund legged into the straddle would be \$14 per share; the basis of Lot 1 after the year-end mark to market would be \$16 per share. If Lot 1 had not been part of a straddle, the average cost would have been \$12.33 per share (200 shares in Lots 1 and 2 at \$11 per share plus 100 shares in Lot 3 at \$15 per share), and no gain or loss would have been recognized.

If Fund later legs out of the straddle after year-end and retains Lot 1, it would need to be added back into the average cost calculation. Presumably, it would be treated as repurchased at the fair market value market at the time the straddle ended. If Lot 1 was worth \$16 per share when the straddle ended, the average cost of the security would

¹⁹ For example, accrual of discount or amortization of premium would have to be redetermined whenever the fund purchased a new lot.

now be \$14 per share (200 shares in Lots 2 and 3 at \$13 per share plus 100 shares in Lot 1 at \$16 per share).

The interaction of the straddle rules and average cost become even more complex in the context of a bond. In addition to determining how the average cost is affected when the bond is legged in and out of the straddle, the rules would have to address how to account for tax adjustments such as market discount and premium.

Significant systems changes would be required to accommodate all of these adjustments and to implement mandatory average cost. No commercial software is available currently that could make these adjustments; any such software would be costly and must be built from scratch. To complicate matters, systems also would need to distinguish between pre- and post-effective date securities, which would be treated as separate accounts.²⁰ The only way to distinguish pre- and post-effective date securities would be to establish separate security identification numbers for each group; this change, however, would have implications for other areas such as regulatory reporting, diversification testing, and wash sale calculations.

Thus, any theoretical benefit of simplification that might arise if average cost were required for the average retail investor holding only a few stocks and bonds does not materialize if applied to investors such as RICs with large portfolios that are actively traded. Average cost, as explained above, is (at best) extraordinarily complicated for these investors. Tax reporting is not simplified. Because we can find no discernable benefit to either the investor or the IRS from applying mandatory average cost, we urge that this proposal be abandoned.

Circumvention of Average Cost

Taxpayers might seek to circumvent a mandatory average cost rule by opening multiple accounts with the same or different brokers to hold identical securities acquired at different times. The taxpayer then could choose among multiple accounts to pick the shares with an “average” basis that maximizes or minimizes capital gain or loss. The only taxpayers who easily could pursue this strategy, however, would be sophisticated and high net worth investors, who would understand the rules or have sophisticated financial advisors, and who easily could open multiple accounts. The average retail investor most likely would neither understand these rules nor have the ability to open multiple accounts. Thus, the negative impact of a mandatory average cost proposal would fall mostly, or perhaps only, on average retail investors, such as those investing in funds.

A mandatory average cost regime cannot eliminate this strategy, unless the proposal foregoes the compliance benefits of broker reporting. Although a broker could average together the same securities held in different accounts at that brokerage firm, a broker will not know the average basis of

²⁰ Under the proposal as written, a separate average cost would be calculated for pre- and post-effective date securities, which would be treated as separate accounts. If average cost applied prospectively only, the basis of pre-effective date securities would be calculated using methods available under current law, and average cost would be used for post-effective date securities.

identical shares held in an account with another broker. The proposal could require the taxpayer to average together cost basis across accounts held by different brokers, but the number reported by the shareholder would not necessarily match the number reported by the broker. As a result, basis reporting by brokers would become less effective for both shareholders and the IRS. Further, extensive guidance would be needed to govern when a broker must average together different accounts held at that same firm. For example, a logical solution to this problem would be a rule that requires a broker to average together two accounts held under identical registration (*i.e.*, the same legal name and taxpayer identification number).²¹ It is not so clear, however, whether averaging across accounts should be required if a customer has an account in his own name and an account with his wife and/or his child or children.

The Lock-In Effect

Eliminating a taxpayer's ability to choose which lots to sell also might encourage an investor to retain securities that otherwise would be sold. This "lock-in" effect could occur if one or more lots of a security had a high cost basis (and thus minimal unrealized gain) while the average cost of all of the lots was far lower. An investor who could specifically identify which lots to sell might do so, given minimal tax consequences, but decide not to sell any shares if average cost basis were required. Retaining securities that would be sold but for the tax consequences reduces optimal portfolio management and market efficiency. This "lock-in effect" already exists, for example, among taxpayers holding highly-appreciated assets and understanding the benefits to their heirs of receiving a stepped-up basis at death. It is unclear what tax policy objective would be served by expanding this lock-in effect. Therefore, we believe that investors should continue to be permitted to choose to manage their gains and losses by utilizing the specific identification method of calculating cost basis.

Effective Dates

If mandatory average cost nevertheless were implemented, it must apply only prospectively. Specifically, any proposal should apply only to shares acquired some reasonable period after the legislation is enacted; this approach (including substantial lead time) was adopted when the cost basis reporting rules were enacted in 2008. The proposal as currently drafted, however, appears to apply both retroactively, to shares already owned, and prospectively.

Average cost, to be properly calculated, requires perfect information regarding the purchase price of every lot and every adjustment to every lot. For shares acquired before mandatory cost basis reporting became effective, this information may not be readily available. Consider, for example, an individual taxpayer who has held a stock or a fund for thirty years, with dividends reinvested each year. This taxpayer may not have precise records of the purchase prices of the older shares. Indeed, the potential lack of precision regarding cost basis of shares acquired previously is the reason cost basis reporting was enacted in the first place. To continue the example, the taxpayer more likely will have better records for more recently acquired shares. The taxpayer thus could calculate correctly the cost

²¹ Even this requirement would raise significant systems and operational challenges.

basis of these newer shares because the specific identification method is available under current law. This same taxpayer could not calculate correctly the cost basis of any shares, however, if average cost were required because the basis of the older shares (which must be averaged with the basis of the newer shares) is not known. Moreover, requiring taxpayers to calculate an average when there have been multiple dividend reinvestments over multiple years may prove to be too difficult for the average investor. Even if this average investor could compute the average of the purchase prices for each lot, it would be less likely that any basis adjustments, such as those arising from wash sales, would be calculated properly.

The problem of requiring the average investor to calculate his or her own average cost is ameliorated, on a going-forward basis only, with mandatory cost basis reporting by brokers. Beginning in 2012 for RICs, 2011 for other equities, and 2014 for debt and options, funds and brokers have all of the information needed to calculate and report cost basis to their shareholders and the IRS for newly acquired securities. Before these effective dates, however, funds and brokers do not have the information necessary to calculate a customer's average cost correctly. Thus, because the use of average cost requires perfect information to properly calculate the average, a mandatory cost basis regime can apply only prospectively.

The only way to bring existing securities into the system would be to mark them all to market as of the effective date. The fair market value of the securities on that date would be the cost basis going forward. This approach would allow brokers to report average cost to the shareholder and the IRS with respect to all securities held by a customer. The result would be grossly unfair, however, as the mark to market likely would result in the current taxation of significant gains on securities that taxpayers otherwise plan to continue holding. The other alternative would be to defer or exclude altogether any gain or loss generated by the mark to market.²²

Broker Reporting

The Committee also should consider the transition dates for broker reporting and transfer reporting under sections 6045 and 6045A. The cleanest and easiest route, from a reporting standpoint, would be to treat all securities acquired before the effective date as "noncovered" with no required reporting by brokers and funds. Shareholders would be permitted to use any method, as under existing law, with respect to these noncovered securities. This option is simple in that it would not add any additional boxes to current forms; there still would be only noncovered and covered securities. The downside is that this option would turn off any reporting for securities acquired between 2011 and the effective date, eliminating any compliance benefit.

A less desirable result would be to have three categories of securities: (1) noncovered securities (those acquired before 2011, 2012, or 2014, depending on the type of security), for which no broker or fund reporting is required; (2) "old" covered securities (those acquired between 2011, 2012, or 2014, depending on the type of security, and the effective date of this proposal), for which broker reporting is

²² Deferral of gains raises additional complications, as brokers and funds would have to keep track of such amounts, possibly for decades, until the securities are sold.

required using any method available under current law; and (3) “new” covered securities (those acquired after the effective date of this proposal) for which broker reporting is required using average cost. This would result in significant implementation and operational issues, as well as shareholder confusion. Forms 1099-B, substitute forms, and tax returns would have to include additional boxes to account for the new covered shares.²³

Significant Lead Time Necessary to Implement Changes

If the Committee moves forward with a proposal to mandate average cost, it must provide significant time before the effective date to allow brokers and taxpayers to build and implement systems needed to calculate and report average cost. As discussed above, brokers currently do not have systems in place to calculate average cost on equities (other than RIC and DRP shares) and debt. Although RICs do have systems in place to calculate and report average cost to their shareholders, they do not have systems necessary to calculate average cost on their own portfolios. Brokers and taxpayers such as RICs would need at least two to three years from the enactment of an average cost proposal to implement the new regime. Significant time is needed to program and test systems and to educate customers. It should be noted that, when mandatory cost basis reporting was enacted in 2008, the Congress delayed the effective date for mandatory cost basis reporting of mutual fund shares and dividend reinvestment plans because they recognized the difficulties of building systems to calculate average cost properly.

Current Accrual of Market Discount

Most taxable bond funds currently elect to accrue market discount; for these funds, the proposal to require such accruals would have no effect. Many municipal bond funds, however, do not accrue market discount currently. Thus, this proposal would accelerate taxable income to investors in these funds. In addition, mandatory current accrual will lead to more cases in which funds would have included accrued market discount in taxable income each year and then had a capital loss when the bond was sold. Consideration should be given to allowing an ordinary loss on disposition of the bond to the extent of any accrued market discount. This result could be particularly important for municipal bond funds.

²³ Current tax forms are already quite complicated, to accommodate the pre- and post-effective date securities as a result of mandatory cost basis reporting. IRS Form 8949, “Sales and Other Capital Transactions” (which is filed by taxpayers as an attachment to their tax returns) contains six separate categories for capital transactions. These are: (1) Long-term capital gains on covered securities; (2) short-term gains on covered securities; (3) long-term gains on noncovered securities; (4) short-term gains on noncovered securities; (5) long-term gains on securities for which a Form 1099-B is not received; and (6) short-term gains on securities for which a Form 1099-B is not received. Substitute Forms 1099-B include the first four of these categories, plus a fifth for securities for which basis and/or holding period is unknown. If mandatory average cost becomes effective after some date, this will add three additional categories to the Form 8949, and two additional categories to the substitute Form 1099-B.

Wash Sales by Related Parties

The related party wash sale proposal, as crafted currently, could apply to several fund-specific situations that do not present tax abuse opportunities. These situations include: (1) variable insurance product funds that are owned by one insurance company; (2) start-up funds, in which the investment management company has invested seed money and owns (temporarily) more than 50% of the fund; (3) fund-of-funds structures; and (4) retirement plans that own more than 50% of a fund. In all of these cases, the wash sale proposal could treat two funds as related parties to which the wash sale rules apply. Alternatively, the proposal could treat a fund and its 50% owner (the insurance company, the investment management company, or the retirement plan) as related parties. Despite common ownership, these funds have independent boards, different investment objectives, and fiduciary duties that prevent any type of collusion or manipulation. Indeed, the funds could be managed by different fund complexes. Any transactions that lead to a potential wash sale would be entirely coincidental. Under this proposal, however, these funds and their common owners would have to track all sales and purchases of substantially identical securities. Given that these are independent entities, it is not entirely clear that this sort of tracking would be possible. Even if it were, we do not believe it is appropriate, because no potential for abuse exists.

If the Committee continues to advance this related party wash sale rule, the situations discussed above (and perhaps others) should be exempted. We would be pleased to work with the Committee to develop appropriate safeguards to ensure that the exemptions we propose could not be used inappropriately by others.

Importantly, it also should be noted that the related party proposal is more punitive than the wash sale rule under current law, because the proposal would disallow any loss permanently (rather than just defer it). Under current law, because the disallowed loss is added to the basis of the purchased shares, the taxpayer ultimately will recognize the loss when the replacement shares are sold. This proposal should provide the same result.

Debt Modifications

The Committee has proposed reforming the rules for determining the issue price of new debt received in a significant modification of existing publicly traded debt. While we support the application of the proposed rule to issuers, it could produce a negative result for holders (including funds and their shareholders) and produce frictions in the debt markets. We thus ask the Committee to modify the proposal to protect holders, as well as issuers.

Under current law, when there is a significant modification of publicly traded debt, the modified debt generally is treated as issued for its fair market value. If the issuer has experienced a decline in its credit rating, or if interest rates have increased such that the debt is offering a below-market return, the fair market value of the new debt (and thus its new issue price) may be less than the debt's stated redemption price. Consequently, the issuer would be required to recognize cancellation of

indebtedness income (“COD”), notwithstanding the fact that the principal amount of the debt has stayed the same.

The proposal would change this result by setting the issue price of the new debt by reference to the issue price of the old debt and the stated redemption price at maturity of the new debt, provided certain criteria are satisfied. If eligible for such treatment, the issuer would not recognize any COD.

Under current law, the tax consequences of a significant modification to a holder depend on whether the deemed exchange from the modification constitutes a “reorganization” for purposes of section 368(a). If the deemed exchange constitutes a reorganization, the holder does not recognize any gain/loss and takes a carryover basis in the modified debt. If the deemed exchange does not constitute a reorganization, for instance, because the issuer is not a corporation or the debt doesn’t constitute a “security,” and thus is ineligible for reorganization treatment under section 368, holders recognize gain/loss based on the difference between the holders’ basis in the existing debt and the issue price of the modified debt (which, again, generally is its fair market value if the debt is publicly traded). The proposal to determine the issue price of the modified debt by reference to issue price of the old debt and stated redemption price at maturity of the new debt (and not fair market value) likely would cause holders who purchased the original debt instruments at a price below their adjusted issue price (either in the original offering or in the secondary market) to recognize phantom gain. Because of the breadth of their portfolios, fixed-income funds likely would be required to recognize gain as a result of this proposal.

We support the Committee’s proposal to shield issuers from recognizing COD when the stated redemption price at maturity of the modified debt remains the same as the original debt; the issuer has enjoyed no forbearance from its obligations and to tax it on that basis is inappropriate. It seems just as inappropriate, however, to measure a holder’s gain in connection with a taxable debt modification of publicly traded debt by reference to the adjusted issue price of the old debt or the stated redemption price of the new debt. The measure of a holder’s gain should instead be determined under general tax realization principles—that is, the difference between the adjusted basis in the old debt and the fair market value of the new debt. We can see no policy reason why shielding a borrower from COD should require a change in the treatment of holders.

In addition, we expect that the debt markets would experience a decrease in liquidity and efficiency as RICs and other investors either forgo purchases of distressed debt that could be expected to undergo a modification, or withhold their consent to debt modifications that otherwise would be economically desirable, if such modifications would give rise to taxable gains. We thus ask that the Committee amend the proposal to allow holders to continue to use fair market value for the issue price of the new debt if the modification is not otherwise eligible for non-recognition treatment.

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The Institute greatly appreciates the opportunity to comment on the important topic of financial products taxation. We look forward to continuing to work with the Committee to advance tax reform and address any concerns for funds and their investors.