# Bond Case Briefs

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## Camp Tax Reform Proposal Affects Financial Services and Transactions.

Richard Larkins, Alan Munro, and Marc Levy review recent tax reform proposals by House Ways and Means Committee Chair Dave Camp, R-Mich., that would affect the financial services industry and users of financial products.

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A tax reform proposal (the 2014 proposal) released by House Ways and Means Committee Chair Dave Camp, R-Mich., contains several provisions of interest to financial product users, as well as the financial services industry.

**A. Marking to Market Derivatives: General Rule**

**1. Proposal.** Under the 2014 proposal, all taxpayers would generally account for all derivatives on a mark-to-market basis, with any resulting gain or loss treated as ordinary in character.

**2. Discussion.** Under current tax law, derivatives generally need not be marked to market unless (1) the taxpayer is a dealer of those derivatives; (2) the taxpayer is a trader or dealer in commodities that has elected to mark them to market; or (3) the derivative is a so-called section 1256 contract (a regulated futures contract, foreign currency contract, non-equity option, dealer equity option, or dealer securities futures contract). The gains and losses resulting from that marking are generally ordinary, although they are 60 percent long-term capital and 40 percent short-term capital for some section 1256 contracts.

Camp's 2013 proposal would largely replace these rules with a requirement to generally account for derivatives annually on a mark-to-market basis, with gain or loss treated as ordinary. Under that proposal, if a taxpayer holds a derivative contract at the beginning of the tax year, proper adjustment is made to any gain or loss later realized on that contract to reflect any gain or loss taken into account by the taxpayer in a prior year. Under the proposal, these mark-to-market rules would apply to all derivatives held by a taxpayer, other than those properly treated as hedging transactions or as part of straddles (as discussed below), even though nonrecognition of gain or loss would have resulted from the application of any other code provision.

The 2013 proposal defines a derivative broadly to include any evidence of an interest in, for example, options, futures, forwards, and swaps. There is no requirement for the underlying property to be publicly traded. The proposed definition of a derivative has a fairly narrow exception for options on real property.

Under the proposal, a derivative generally includes any embedded derivative component of a debt instrument. However, the proposal would exclude most debt instruments with embedded derivatives, so as a practical matter, it would apply only to convertible debt instruments. The proposal is unclear on how the tax rules would apply to the debt instrument once the derivative component had been isolated and subject to mark-to-market accounting.

Although generally similar to the 2013 proposal, the 2014 proposal contains some differences. Notably, a derivative is more narrowly defined as a contract "with respect to," rather than just evidence of an interest in, specified underlying property. Carved out from the definition of a derivative are the following: the right to the return of the same or substantially identical securities transferred in a securities lending, sale-repurchase, or similar financing transaction; some options received in connection with the performance of services; insurance contracts, annuities, and endowments; derivatives regarding the stock of members of the same worldwide affiliated group; commodities used in the normal course of a trade or business; and American depository receipts for foreign stock.

The 2014 proposal retains the rule that the term "derivative" includes a contract with an embedded derivative component, but it would expand the 2013 proposal's exception for some debt instruments by excluding from mark-to-market treatment convertible debt instruments, contingent payment debt instruments, integrated debt instruments, variable rate debt instruments, investment units, debt with alternative payment schedules, and other debt instruments to which the section 1275(d) regulations apply. The 2014 proposal also instructs the Treasury secretary to modify regulations under section 1275(d) to provide that convertible debt instruments are treated in a manner similar to contingent payment debt instruments. Thus, unlike the 2013 proposal, the 2014 proposal would not treat convertible debt instruments as having an embedded derivative component and would tax those instruments as contingent payment debt instruments.

**3. Implications.** While the proposal to mark to market derivatives would be a significant departure from current law, the 2014 proposal's narrowing of the definition of a derivative is welcome, particularly as it relates to debt instruments. The proposal to tax convertible debt instruments under the contingent payment debt instrument rules would be a big change.

Neither proposal contains a requirement for either the derivative itself or the underlying property to be publicly traded. There is no requirement for there to be underlying property, at least in some cases. This would greatly expand the range of transactions to which the mark-to-market requirements could apply. For example, agreements to buy or sell any stock in a corporation or an interest in a partnership would have to be marked to market. Finally, the mark-to-market rules might apply to many real estate transactions, including leases and sale transactions involving multiple properties.

**B. Marking to Market Derivatives: Straddle Rule**

**1. Proposal.** The 2014 proposal contains a special rule regarding a taxpayer's entry into specified offsetting positions (straddles).

**2. Discussion.** For purposes of this rule, the term "straddle" means offsetting positions regarding actively traded personal property, and the term "mixed straddle" means a straddle that contains a derivative and at least one offsetting position that would not be marked to market under general rules (for example, common stock).

The 2013 proposal focused on mixed straddles. Thus, if a taxpayer entered into a mixed straddle and, when that occurred, a position had a built-in gain, the gain position would be treated as sold for its fair market value at the time of entering into the mixed straddle. If the position had a built-in loss, however, the position would not be treated as sold at the time of entering into the mixed straddle, and the amount of the built-in loss would not be taken into account in determining the amount that is marked to market during the period of the mixed straddle. Rather, the amount of the loss would be taken into account in determining the amount of gain or loss when the position is disposed of in a transaction in which gain or loss is otherwise recognized. In either case, the mark-to-market and ordinary rules would apply to future gains and losses on both the derivative and the nonderivative positions (except for any deferred built-in loss on the non-mark-to-market position in the mixed straddle).

The 2014 proposal is the same as the 2013 proposal, except it excludes some positions regarding debt subject tosection 860G(a)(1)(B)(i) and straddles consisting of long stock and qualified covered call options.

**3. Implications.** Both proposals go well beyond current law in triggering the recognition of gain on a financial asset when the taxpayer enters into a risk-reduction transaction for that asset. Under current law, gain recognition is not triggered unless the taxpayer eliminated substantially all its risk of loss and opportunity for gain on the asset. Under either proposal, any substantial diminution of the risk of loss or opportunity for gain would be sufficient to trigger the recognition of gain for tax purposes but would not result in the recognition of loss. Moreover, unlike the existing straddle rules, this one-sided rule would apply to entering into contracts to sell all the stock of a corporate subsidiary. Doing so would trigger the recognition of gain when the contract is executed, and additional gain or loss would need to be determined when the stock is delivered under the contract.

### C. Marking to Market Derivatives: Hedging

**1. Proposal.** Both proposals' mark-to-market treatment of derivatives (and offsetting positions with built-in gain) would not apply to any derivative that is part of a properly identified hedging transaction. Under the proposals, hedging transactions that are properly identified as such for financial accounting purposes (that is, under generally accepted accounting principles) would be treated as meeting the hedge identification requirement of section 1221.

**2. Discussion.** Under current law, tax hedging treatment is available only if the risk of being hedged relates to ordinary property held (or to be held) or obligations incurred (or to be incurred) by the taxpayer. Further, for a hedging transaction to unambiguously qualify for ordinary gain or loss treatment, it must be timely identified for federal income tax purposes as a hedging transaction in the taxpayer's books and records. To be timely, the identification statement must be completed by the end of the day on which the hedging transaction is entered into. Under current Treasury regulations, an identification of the transaction as a hedge for GAAP purposes does not satisfy the requirement to identify the transaction for federal income tax purposes.

As a consequence, many taxpayers are treated as having failed to properly identify their hedging transactions for federal income tax purposes, even though they have completed extensive documentation identifying the transaction as such for GAAP purposes under circumstances in which the transaction is obviously functioning as a hedge. Many taxpayers erroneously rely on their GAAP documentation for federal income tax purposes. This requirement is therefore a trap for the unwary.

Under the 2013 proposal, a hedging transaction would be treated as meeting the hedge identification requirement under section 1221 if the transaction were identified as a hedging transaction for tax purposes (as required under existing law) or if the transaction were treated as a hedging transaction within the meaning of GAAP for purposes of the taxpayer's audited financial statement. The statement must be certified as being prepared in accordance with GAAP by an independent auditor and must be used for purposes of a statement or report to shareholders, partners, other proprietors, or beneficiaries, or for credit purposes.

The 2014 proposal is the same as the 2013 proposal except that it makes tax hedging treatment more attainable to insurance companies by providing that any bond, debenture, note, certificate, or other evidence of indebtedness held by an insurance company shall be treated as ordinary property for purposes of the tax hedging rules (and thus, potentially eligible for tax hedging treatment). Further, the 2014 proposal broadens the exception from foreign personal holding company income treatment for income arising out of commodity hedging transactions.

**3. Implications.** The proposals' hedging exception to marking to market would remove most derivatives used by business taxpayers but would not eliminate the difficulties posed by the adoption of a general mark-to-market system. The proposal to trigger immediate gain (but not loss) recognition if a derivative creates a straddle is particularly troubling. First, many economic exposures involve capital assets, which cannot be the subject of a tax hedge, even if the taxpayer attempts to identify them as such. Second, many U.S. multinationals enter into hedging transactions in their controlled foreign corporations, and the rules under subpart F frequently require careful planning to properly match gain or loss on a hedge with loss or gain on the hedged item. The proposals provide only limited help in addressing these potential mismatches. In the subpart F context, the proposals may worsen the effect of inadvertent errors made by a taxpayer because, under a mark-to-market system, a taxpayer will be unable to control the timing of income. Timing and character mismatches will therefore be even more difficult to avoid.

The extension of tax hedging treatment to debt instruments held by insurance companies to economically hedge their insurance policies is welcome.

The automatic identification system would be a welcome change, but it would not eliminate the need for taxpayers to pay attention to required tax identifications. This is primarily because many exposures that can be hedged for tax purposes cannot be hedged for financial accounting purposes, and therefore will not have been identified as hedges by the taxpayer.

**D. Corporate Acquisition Indebtedness: Repeal**

**1. Proposal.** The 2014 proposal would repeal section 279 in its entirety.

**2. Discussion.** Under current law, if specified conditions are met, a corporation's interest deduction may be denied for debt issued as consideration for the acquisition of stock in another corporation or of assets of another corporation. The 2013 proposal did not address this.

**3. Implications.** The repeal of section 279 is a welcome proposal because its many conditions means it rarely applies and is not a large revenue raiser. Thus, repealing this provision is unlikely to have much effect, while it would streamline the code.

**E. Inclusion in Income of Market Discount**

**1. Proposal.** The 2014 proposal would require purchasers of bonds at a discount on the secondary market to include the discount in ordinary income over the remaining life of the bond. The proposal would limit market discount inclusion to an amount that approximates increases in interest rates since the loan was originally made by using a maximum accrual rate equal to the greater of (1) the original yield on the bond plus 5 percentage points or (2) the applicable federal rate plus 10 percentage points.

**2. Discussion.** Under current law, a taxpayer is not generally required to include market discount in income as it accrues but may elect to do so. Gain on the disposition of any market discount bond is treated as ordinary income to the extent of the accrued market discount, which generally accrues ratably unless the taxpayer elects to accrue it based on a constant interest rate. No exception exists for the accrual of market discount on distressed debt when there may be no reasonable expectation of full collection. Nor is there any rule limiting the rate at which market discount accrues to a reasonable market rate of interest.

Under the 2014 proposal, the holder of a market discount bond would include market discount in gross income as it accrues. The amount of the inclusion for any tax year would be computed based on a constant interest rate. For bonds with both market discount and original issue discount, the constant interest rate accrual would be reduced by the OID accrual to avoid double counting.

The 2014 proposal is largely the same as the 2013 proposal regarding market discount, with two exceptions. First, under the 2013 proposal, the capped yield would apply to a hypothetical purchase price, which would result in the bond having the capped yield rather than the actual purchase price. This appeared to be a drafting error. Under the 2014 proposal, the capped yield applies to the adjusted purchase price.

The second difference is that under the 2014 proposal, a holder would treat any loss that results from the disposition of a market discount bond as ordinary (rather than capital) loss to the extent of previously accrued market discount.

**3. Implications.** While the proposal is welcome in that it would limit the accrual of market discount on severely distressed debt (and thus conform the tax law more closely to the holder's economic reality of doubtful collectability), taxpayers would be forced to currently include in income market discount as it accrued. That latter aspect of the proposal could significantly affect future years if interest rates rise significantly. Further, the proposal does not solve the overaccrual problem with severely distressed debt when the full recovery of principal is highly uncertain, and quite arguably, zero accrual is the correct answer. It is also unclear from the Camp proposal whether it is intended to supersede any common-law doctrines that permit zero accrual in severely distressed debt cases.

The two changes from 2013 are improvements. The drafting error was fixed, which was expected. Treating loss as ordinary (to the extent of previously accrued market discount) could ease the problem of character whipsaw for a taxpayer that purchased distressed debt and was required to include market discount before selling the debt at a loss.

**F. Treatment of Exchanges of Debt Instruments**

**1. Proposal.** Under current law, an issuer can recognize cancellation of debt income (CODI) in a debt-for-debt exchange of publicly traded debt, even though the issuer remains liable for the full amount of the principal. The 2014 proposal would prevent this by generally providing that the issue price of a modified debt instrument cannot be less than that of the debt instrument before modification. This floor on the issue price of the modified debt instrument would be reduced by any amount of principal that is forgiven or by any imputed interest arising from a failure of the new debt to state interest at least at the applicable federal rate.

The 2014 proposal also would generally prevent the holder of a debt instrument from recognizing gain or loss as a result of the modification of the debt.

**2. Discussion.** If the terms of a debt instrument are altered in a manner that constitutes a significant modification of the instrument (which results in a deemed debt-for-debt exchange of the existing debt instrument for the modified instrument), the tax consequences for both the issuer and holder largely depend on the issue price of the modified debt instrument. In determining the issuer's CODI, the issuer is treated as having satisfied the existing debt for an amount of money equal to the issue price of the new modified debt. Thus, to the extent the issue price of the modified debt is less than the adjusted issue price of the existing debt, the issuer will recognize CODI (without, of course, receiving any cash with which to pay the tax on that income, since the issuer already received the cash when it incurred the debt). Further, the issue price of the modified debt will also determine whether the issuer has OID and whether the applicable high-yield discount obligation (AHYDO) rules, which can operate to deny or defer interest expense deductions attributable to the OID, would apply. For the holder, the issue price of the modified debt determines its amount realized in the debt-for-debt exchange and thus its gain or loss (although that gain or loss may not be recognized currently under the corporate reorganization provisions). Under current law, the issuer may recognize CODI on restructurings of publicly traded debt when the issuer's creditworthiness has declined or market rates have increased, even if the principal amount of the debt has not changed. The CODI would generally be offset over time with deductions for OID, but the AHYDO rules or other interest limitations may restrict this.

The 2014 proposal seeks to rectify these results by providing that for an exchange (including by significant modification) by an issuer of a new debt instrument for an existing debt instrument from the same issuer, the issue price of the modified debt instrument shall be the lesser of (1) the adjusted issue price of the existing debt instrument; or (2) the issue price of the modified debt instrument — that is, the principal amount, if there is adequate stated interest or, otherwise, the imputed principal amount — which would be determined under section 1274 if the debt instrument were an instrument to which that section applied.

The 2014 proposal would also change the taxation of holders of debt instruments in actual and deemed debt-for-debt exchanges. This would address the problem that arises if a holder has a low basis in the old debt, and the issue price equals its face amount, as would be the case under current law if the debt is not publicly traded and would often be the case under either proposal regardless of public trading. In that case, absent a special rule, the holder recognizes gain equal to the excess of the face amount over its basis, even though there may be no economic gain. The 2014 proposal would address this problem by providing that an actual or deemed debt exchange is to be treated from the holder's perspective as a nontaxable transaction with carryover basis, regardless of whether the debt qualified as a corporate security under subchapter C. The 2014 proposal's treatment of holders in this situation differs from the 2013 proposal, which did not address the problem from the holder's perspective.

**3. Implications.** The 2014 proposal would be welcome relief if enacted. From an issuer perspective, it would prevent issuers from realizing phantom CODI from restructurings of their public debt when the principal amount remains the same. Holders would also be prevented from realizing phantom gain from a deemed debt exchange when there was no economic gain.

**G. GAAP Income Acceleration**

**1. Proposal.** The 2014 proposal would modify section 451 generally in section 3303 of the 2014 proposal and further expand it for specified debt in section 3413, discussed below, by directing taxpayers to apply the revenue recognition rules under section 451 before the OID rules under section 1272.

**2. Discussion.** The holder of a debt instrument with OID generally accrues and includes in income (as interest) the OID over the term of the instrument. Under current law, some fees earned by credit card issuers and other financial institutions have been treated as OID income, which allows these institutions to postpone the realization of this income to later years for tax purposes. Under the 2014 proposal, these fees and other amounts received by a taxpayer would not be treated as OID, which would require accrual method taxpayers to include an item of income no later than the tax year in which that item is included for financial statement purposes.

The proper tax treatment of various fees paid by credit card users has been a long-standing issue. The question is whether those fees should be treated as interest, in which case credit card issuers can defer recognition of the fees as OID, or as income currently includable in the year the fees are assessed. For years, authorities addressing the matter were somewhat unclear and incomplete. For example, in Rev. Proc. 2004-33, 2004-1 C.B. 989, the IRS states that it would permit late fees imposed by credit card issuers to be treated as interest if specified conditions were met. The IRS held that over-limit fees were not interest in Rev. Rul. 2007-1, 2007-1 C.B. 265, but took a contrary position in TAM 200533023 under somewhat different facts.

In 2009 the Tax Court held in *Capital One Financial Corp. v. Commissioner*[1] that interchange fees are a form of OID on credit card loans and not a fee for services, meaning that credit card issuers could defer recognition of the fees. The Fourth Circuit affirmed the decision in 2011. After *Capital One*, the IRS announced that it will no longer challenge the position that interchange fees are OID.

The 2014 proposal would prevent credit card issuers and other financial institutions from treating credit card fees as interest that may be deferred under the OID rules.

**3. Implications.** The 2014 proposal would essentially overrule *Capital One* and any other authority supporting the position that credit card fees are OID. The proposal would require credit card issuers and other financial institutions to include fees in income no later than the year in which the fees are included for financial statement purposes, which generally means the year the fees are assessed.

### H. FIFO Basis Calculation: Sales of Securities

**1. Proposal.** The 2014 proposal attempts to simplify tax compliance and administration by requiring the cost basis of a security to be determined on a first-in, first-out basis.

**2. Discussion.** Under section 1001, the gain or loss recognized on the sale or exchange of property is the difference between the amount realized on the sale and the taxpayer's adjusted basis, as defined under section 1011. To compute the adjusted basis, a taxpayer must determine the property's original, unadjusted basis, generally its cost, under section 1012 and make required adjustments. Determining basis is complicated when a taxpayer has acquired stock in a corporation on different dates or at different prices and sells or transfers less than all of the shares of the stock. If a taxpayer does not adequately identify a lot from which the stock is sold or transferred, a FIFO rule applies. If, however, the taxpayer makes an adequate identification of the shares sold, the shares identified are treated as sold.

Under the 2013 proposal, the cost of any specified security sold, exchanged, or otherwise disposed of would be determined using an average basis method. The 2014 proposal would abandon this method and instead proposes that the taxpayer determine basis (and the holding period) on a FIFO basis. As in the 2013 proposal, a specified security includes any share of stock of a corporation, evidence of indebtedness, a commodity, or a contract or derivative regarding that commodity.

**3. Implications.** As with the 2013 proposal, the 2014 proposal would remove the taxpayers' ability to identify sold securities with an eye toward reducing tax liability. The 2014 proposal should be seen as an improvement on the 2013 proposal, however, because it eliminates the uncertainty regarding the computation of the taxpayer's holding period. Holding periods are important for individual taxpayers who can benefit from reduced long-term capital gain rates on securities held longer than 12 months.

### I. Wash Sale Rules Extended to Related Parties

**1. Proposal.** Like the 2013 proposal, the 2014 proposal would expand the current wash sale rules, which prevent a taxpayer from claiming a benefit by selling at a loss and quickly repurchasing the same security.

**2. Discussion.** Under current section 1091(a), a taxpayer realizing a loss upon the sale or other disposition of stock or securities may not deduct the loss if the wash sale rules apply. The wash sale rules apply if, within a period beginning 30 days before the date of the sale or disposition and ending 30 days after that date, the taxpayer has acquired, or has entered into a contract or option to acquire, substantially identical stock or securities. When a loss is disallowed because of the wash sale rules, the disallowed loss is added to the cost of the new stock or securities to arrive at a new basis for the new stock or securities (except for new stock or securities purchased through an IRA). The effect of this basis increase is that the taxpayer is placed in the same position as if he had never sold the stock or securities.

As written, section 1091(a) only applies when the taxpayer, but not a related party, reacquires (or enters into a contract or option to reacquire) substantially identical stock or securities.

As with the 2013 proposal, the 2014 proposal would modify section 1091 by treating a sale and subsequent repurchase as a wash sale when a related party reacquires the stock or securities sold. For this purpose, a related party is (1) the taxpayer's spouse; (2) any dependent of the taxpayer or any person for whom the taxpayer is a dependent; (3) any individual, corporation, partnership, trust, or estate that controls or is controlled by the taxpayer or individuals described in (1) or (2); or (4) any IRA, qualified tuition program, employee benefit plan, or deferred compensation plan for individuals described in (1) or (2). The proposal also provides that the Treasury secretary shall issue regulations or other guidance to prevent the avoidance of the purposes of section 1091.

**3. Implications.** The 2014 proposal would curb what would frequently be a transaction to harvest losses. However, it could also function as a trap for the unwary because it could potentially result in a permanent disallowance of the loss rather than mere deferral of it. Under the proposed modification, the disallowed loss would not increase the security basis of any related party, except for that of a spouse. Moreover, it is unclear how significant the change is, given existing common law doctrine that has attempted to curb several similar situations.

### J. Derivative Transactions: Corporation's Stock

**1. Proposal.** Under the 2014 proposal, a corporation generally would not recognize income, gains, losses, or deductions for derivatives that relate to the corporation's own stock, except for some transactions involving the corporation acquiring its own stock and entering into a forward contract regarding that stock.

**2. Discussion.** Under current section 1032(a), a corporation does not recognize gain or loss on the receipt of money or other property in exchange for its own stock. Further, a corporation does not recognize gain or loss on any lapse or acquisition of an option, or regarding a securities futures contract, to buy or sell its own stock.

The 2014 proposal would modify section 1032(a) so that section 1032 derivative items of a corporation are generally not taken into account in determining the corporation's tax liability. Section 1032 derivative items include any item of income, gain, loss, or deduction that arises (1) out of rights or obligations under any derivative, to the extent that derivative relates to the corporation's stock; or (2) under any other contract or position to the extent the item reflects or is determined by reference to changes in the value of the stock or distributions thereon. The term "derivative" is defined by reference to proposed new section 486 and thus includes any option, forward contract, futures contract, short position, swap, or similar position. In conjunction with proposed new section 76, the proposal would require a corporation to recognize income to the extent that a receipt of a contribution of money or property exceeds the value of the stock issued in exchange therefor and to recognize income from the receipt of any premium received for an option on its own stock. Finally, the nonrecognition rule in section 1032(a) would not apply if a corporation acquires its own stock, and the acquisition is part of a plan under which the corporation enters into a forward contract for its stock. In that case, the corporation includes the excess of the amount to be received under the forward contract over the FMV of the stock when the forward is entered into as if the excess were OID on a debt instrument. There is a rebuttable presumption that the stock acquisition forward contract is part of a plan if the forward is entered into within 60 days, beginning 30 days before the corporation acquires the stock.

**3. Implications.** The 2014 proposal would provide welcome clarity regarding the scope of transactions that qualify for nonrecognition under section 1032. However, the 2014 proposal may impose additional compliance burdens on some corporate taxpayers, depending on how the exception applies to complex financial instruments.

**K. Dealers in Tax-Exempt Debt**

**1. Proposal.** Section 3124 of the 2014 proposal would apply to all corporations the rule requiring pro rata allocation of interest expense, which today applies only to specified financial institutions.

**2. Discussion.** This would repeal the provision currently in effect for dealers in tax-exempt obligations (when the dealer is not otherwise a specified financial institution), allowing for no interest expense disallowance if the debt is not directly traceable to the tax-exempt bonds; and if the average adjusted basis of the dealer's tax-exempt bonds is 2 percent or less of the average adjusted basis of all assets held by the dealer in the active conduct of its trade or business.

**3. Implications.** This proposal is likely to dramatically affect the after-tax economics for dealers in tax-exempt bonds.

**L. Proposed Excise Tax on Large SIFIs**

**1. Proposal.** Section 7004 of the 2014 proposal includes a groundbreaking excise tax estimated to raise more than $86 billion in revenue over 10 years from fewer than 10 companies.

**2. Discussion.** The targets of the tax are corporations designated as systemically important financial institutions (SIFIs) under the Dodd-Frank Act (DFA) with greater than $500 billion in total consolidated assets. The term "consolidated assets" is defined by reference to section 165 of the DFA. Although not free from doubt, the regulations under section 165 of the DFA appear to count only the assets underneath the intermediate holding company. For the largest foreign banking organizations operating in the United States, only the U.S. assets would count toward the consolidated assets determination. This would result in none of the non-U.S.-headquartered global systemically important banks operating in the United States being subject to the new excise tax. The 2013 proposal did not include a similar section.

**3. Implications.** Based on the most recent information published by the Federal Reserve, those intended to be covered would be JP Morgan Chase, Bank of America, Citigroup, Wells Fargo, Goldman Sachs, and Morgan Stanley. The large nonbanks designated by the Financial Stability Oversight Council as SIFIs (GE Capital, AIG, and Prudential) also appear to be covered. The tax, paid quarterly, equals 0.035 percent of the SIFI's total consolidated assets (as reported to the Federal Reserve) exceeding $500 billion. Under the proposal, the tax would begin to apply in the first quarter of 2015. This new excise tax appears to be deductible for federal income tax purposes. According to the House Ways and Means Committee explanation, the stated rationale for the proposed new tax is to charge the large SIFIs for the "implicit subsidy" allowed to those organizations under the DFA. In a recent press report, however, Camp indicated that at least part of the rationale was based on his sense that most financial institutions will be better off under the overall provisions of the plan and that the excise tax is a way to equalize the effects.

**M. Limitation on Deduction for FDIC Premiums**

**1. Proposal.** A percentage of assessments for FDIC insurance would be nondeductible for institutions with total consolidated assets that exceed $10 billion. The percentage of nondeductible assessments would equal the ratio of the total consolidated assets exceeding $10 billion to $40 billion. An institution with total consolidated assets exceeding $50 billion would have total disallowance of the premium amount. The provision would be effective for tax years beginning after 2014.

**2. Discussion.** Under current law, the premiums paid by banks for FDIC insurance are deductible. The provision is intended to correct for the fact that when the FDIC determines the amount of assessments that are necessary to maintain an adequate balance in the Deposit Insurance Fund, it does so on a pretax basis and does not take into account the deductibility of the premium payments. The tax deductions diminish the general Treasury fund and result in an effective transfer from the U.S. treasury to the Deposit Insurance Fund.

**3. Implications.** Reputedly targeted at large banks, the threshold for this provision is low enough that it may even trap some of the larger community banks. In conjunction with the proposed excise tax on large financial institutions, this provision likely will be seen as unfair by banks.

**FOOTNOTE**

[1] 133 T.C. 136 (2009), *aff'd*, 659 F.3d 316 (4th Cir. 2011).

by Richard Larkins, Alan Munro, and Marc Levy