

April 27, 2018

By Electronic Delivery

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Mr. William Paul
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Internal Revenue Service
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RE: Request for Section 451(b) guidance regarding certain debt instruments with discount

Dear Mr. West and Mr. Paul,

Section 13221 of P.L. 115-97 (commonly known as the Tax Cuts and Jobs Act of 2017, or the “TCJA”) enacted new rules under Section 451(b) of the Internal Revenue Code¹ governing the taxable year of inclusion of gross income for taxpayers that prepare an applicable financial statement under generally accepted accounting principles (“GAAP”). The Securities Industry and Financial Markets Association’s Asset Management Group (“SIFMA AMG”)² represents banks, broker dealers, and asset managers whose clients may be affected by these new rules.

New Section 451(b) creates a number of questions for accrual-method taxpayers investing in bonds and other similar debt instruments. As explained below, there is disagreement among practitioners about the interaction of Section 451(b) and certain rules of Part V of Subchapter P of the Code, leaving a number of questions concerning implementation. Members’ most significant and time-sensitive issues relate to market discount and original issue discount (“OID”) (collectively, “discount”), and we are writing to urge you to clarify in the near term that new Section 451(b) does *not* apply to (i) market discount or (ii) OID (if such OID is treated as discount for GAAP³).

¹ Except as otherwise expressly provided herein, all section references herein are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

² SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG’s members represent U.S. and global asset management firms whose combined assets under management exceed \$39 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. For more information, visit <http://www.sifma.org/amg>.

³ We note that GAAP does not distinguish between market discount and OID. Rather, both types are labeled as “discount” for GAAP, which is accrued over the term of a bond or other debt instrument.

If that is not possible in the near term, then, in the interim, we would strongly encourage you to release transitional guidance delaying implementation of new Section 451(b) in the case of bonds and other debt instruments that have market discount and/or OID (if such OID is treated as discount for GAAP) until guidance resolving these uncertainties can be provided. Specifically, we would suggest a delay to the first taxable year beginning on or after a date that is at least 12 months after the date guidance resolving these uncertainties is finalized (i.e., issuance of final regulations).

Background.

Section 451 states that an accrual method taxpayer include items of income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy (the “all events test”).⁴ Under new Section 451(b), for an accrual method taxpayer, the all events test is treated as met not later than the taxable year in which such income is taken into account as revenue in an applicable financial statement. Accrual method taxpayers with an applicable financial statement are directed to apply the income recognition rules under Section 451(b) before applying the special rules under Part V of Subchapter P (Sections 1271-1288).⁵ These changes to Section 451 have created a number of questions and uncertainties for our members concerning the interplay between the new Section 451(b) and the existing tax rules in Part V of Subchapter P relating to discount on bonds and other debt instruments.

Market Discount.

Under Section 1276(a) of the Code, a taxpayer does not recognize market discount as income until disposition or partial principal payments of the bond to which the market discount relates. Though Section 1276(a) requires accruals of market discount, in the absence of an election under Section 1278(b), these accruals are not recognition events. As such, for tax purposes, the general rule is that market discount is recognized on a *realization* basis. Further, Section 1276(a) also requires that market discount be treated as ordinary income when recognized (and not as capital gain or loss). For that reason, the market discount rules are often thought of as primarily a gain recharacterization regime.

With the passage of the TCJA, our members now question whether new Section 451(b) changes the operation of the Code’s existing market discount rules. While it is relatively clear that certain types of income were considered when drafting the new Section 451(b), such as certain credit card fees and other similar items that are *not* treated as discount for GAAP,⁶ it is not at all clear that Congress intended new Section 451(b) to apply more broadly to market discount (or, as explained in the next section, OID that is discount for GAAP). Our understanding is that most tax professionals agree that the better view is that Section 451(b) does not override the long-standing market discount rules under Section 1276. They reason that the rules require realization-based recognition of

⁴ See new Sec. 451(b)(1)(C) (adding definition of all events test to the Code); Treas. Reg. Sec. 1.451-1 (articulating the all events test under prior law).

⁵ Sec. 451(b)(2). One reason for the reference to Part V of Chapter P was to make clear that Congress intended to reverse the result in *Capital One Financial Corp. v. Comm’r*, 133 T.C. 136 (2009) a case that is also cited in the Conference Report on the TCJA. H.R. Conf. Rep. No. 115-466, n.870 (the “Conference Report”) (available at <https://www.congress.gov/115/crpt/hrpt466/CRPT-115hrpt466.pdf>)

⁶ Conference Report at 427.

accrued market discount and therefore the all events test of Section 451 has never been, and still is not, relevant. Footnote 872 of the conference report to the TCJA supports this reasoning as it reads: “The provision does not revise the rules associated with when an item is realized for Federal income tax purposes and, accordingly, does not require the recognition of income in situations where the Federal income tax realization event has not yet occurred.”⁷ However, given the language of Section 451(b) with its reference to Part V of Subchapter P, some tax professionals at various accounting and law firms are wrestling with Section new 451(b)’s intended scope, and are finding it difficult to reach broad consensus on the strength of the position that Section 451(b) does not apply to market discount.

Absent clear guidance, we are concerned that this could be a situation where similarly-situated taxpayers take opposite tax positions. Focusing on mutual funds, for example, many follow the plain statutory scheme of Section 1276(a), recognizing accrued market discount on a realization basis for tax purposes even though this results in a book-tax difference.⁸ This is particularly the case for tax-exempt bond funds where, unlike stated interest and OID, market discount is treated as taxable income.⁹ As long as there is uncertainty as to whether Section 451(b) is meant to override Section 1276(a) and thus pick up, on a current basis, accrued market discount, it is possible that some funds will take it into income currently while others will not, solely based on who advises the fund. This would be unfair to fund shareholders and potentially create competitive imbalances in the mutual fund industry, and could also disrupt liquidity and pricing in the municipal bond market as investors and funds reconsider whether to purchase bonds with market discount (especially in a rising rate environment).

A lack of clear guidance will also strongly impact administration, operations and policy. Continuing with mutual funds, certainty is required for the funds to accurately make, tax report, and withhold on distributions. Absent further guidance or an implementation delay, funds will need to take a position with respect to the applicability of Section 451(b) for their taxable years beginning in 2018. Because mutual funds have staggered fiscal (tax) year ends (i.e., many complexes will have funds with fiscal (tax) years ending each quarter or even each month of a year), there are already many funds for which this is a very live issue and they consequently need to make decisions about the impact of Section 451(b) in the very near term. If a fund starts taking market discount into income currently, this will impact the character and amount of that fund’s distributions for the year. This can mean the acceleration of taxable ordinary income, which could lead to shareholder confusion, particularly for tax-exempt bond funds, as shareholders could receive unexpected amounts of taxable distributions (i.e., disproportionate to the amount of market discount bonds sold that a year).

⁷ Id. at n.872. Some tax professionals also cite the reference in Section 451(b) to “revenue” for GAAP and argue that it is unlikely market discount would be treated as “revenue” for GAAP by taxpayers who are not in the lending business, in particular those making passive investments in bonds, while others argue that if one considers the market discount rules as primarily being a gain recharacterization regime, the all-events test is irrelevant and as such new Section 451(b) should not impact when market discount is recognized.

These are just some of the arguments available. This letter is not intended to be an exhaustive or technical analysis of this issue.

⁸ GAAP requires current accrual of market discount.

⁹ Because taxable bond funds are less concerned with the taxability of market discount, some currently elect under Section 1278(b) to recognize market discount as it accrues, largely to avoid book-tax differences.

On the other hand, if a mutual fund continues under the current Section 1276(a) rule, but guidance is later released stating that Section 451(b) is meant to pick up accrued market discount effective for 2018 taxable years and beyond, a change of this sort would impact the character and potentially amount of distributions already made by the funds and potentially even require retroactive Form 1099-DIV reporting to shareholders and the Internal Revenue Service (“IRS”) as well as withholding changes. This would be a huge operational endeavor and a headache for both the IRS and for taxpayers who could have to re-file prior year tax returns to report new taxable income. These results are extremely undesirable, will be difficult to explain to retail shareholders, and have the potential to harm the standing of the mutual fund industry with those investors. Moreover, such a change could also result in securities law concerns, including timely and accurate shareholder disclosure for some funds, which could also be quite complicated operationally.

Lastly, as discussed above, although we do not believe this is the better interpretation of new Section 451(b), if Treasury were to determine that the new Section 451(b) requires current income accruals for market discount (thus overriding Section 1276(a)), adequate time and transition rules would be needed for all impacted taxpayers, including the manner of how to switch from Section 1276(a) to current realization of GAAP accruals. Funds and their administrators, in particular, would need time to get their systems in order so as to implement the changes. Depending on materiality for a particular fund, its prospectus or other SEC-filed disclosure materials could need to be modified as well and sales and marketing personnel could, in turn, need to update their communications and message such changes to their customers. Both of these processes could take significant time and investment.

Our members would also need guidance on how to implement new Section 451(b) current income accruals. Most significantly, this includes guidance on whether Section 481 adjustments would be required or whether instead a cut-off method is available. If a Section 481 adjustment is required, guidance would also be needed regarding how funds should calculate those adjustments as this will directly impact their 2018 and later-year income calculations and, in turn, the amount of distributions needed to avoid fund-level income and excise taxes as well as potentially to maintain their qualification as regulated investment companies. Further, this guidance would need to account for the complexities and questions associated with the TCJA’s special implementation rules for debt instruments with OID—i.e., the delayed effective date to 2019 tax years and extended 6-year period for taking in the Section 481 adjustment. A single fund could have bonds with both OID and market discount and bonds with only market discount or only OID, creating an odd result and an unworkable situation from an operational perspective.¹⁰ There are a number of other implementation issues that we believe would need to be addressed.¹¹

¹⁰ This bifurcated effective date for debt instruments with OID and market discount (2019) and those with only market discount (no OID) (2018) also strongly suggests that Congress did *not* intend market discount to fall within scope of new Section 451(b).

¹¹ These other implementation issues for which we would need guidance include whether market-discount bonds acquired prior to the TCJA effective date would be grandfathered and how a taxpayer would implement Section 451(b) (e.g., does it make a Section 1278(b) election and follow those rules?). We would be happy to discuss these with you in more detail.

Other Issues.

Section 451(b) creates other issues related to its interaction with bonds and similar instruments subject to Part V of Subchapter P. In many cases, the GAAP and tax schedules for accrual of discount on bonds (whether OID or market discount) are identical or substantially similar (though, as described earlier, the accrued market discount is not recognized until disposition unless a special election is made). As noted above, while we think the better view is that new Section 451(b) does *not* apply to (i) market discount or (ii) OID in cases where such OID is treated as discount for GAAP, if Treasury were to determine otherwise, funds and other accrual-basis taxpayers with financial statements would be faced with additional operational burdens with little, if any, benefit for the Treasury. For instance, to fully implement new Section 451(b), taxpayers owning bonds with OID treated as discount for GAAP would have to continuously compare their GAAP and tax accrual schedules and adjust the tax accrual schedules in cases where the GAAP accrual exceeds the tax accrual—again, likely only to minor degrees. Mutual funds can hold hundreds or even thousands of these bonds in their portfolios, creating significant burdens yet yielding little or no benefit for the Treasury.

Also, while the tax rules have a *de minimis* threshold for market discount and OID¹², the GAAP rules do not, creating another set of uncertainties. For instance, following passage of the TCJA, is a fund now required to realize, on a current basis, and treat as ordinary income, that *de minimis* discount for tax because it is accruing this *de minimis* amount for GAAP? The conference report to the TCJA does not seem to contemplate this type of situation (i.e., where GAAP and tax have the *same* treatment). Rather, the focus was on certain credit card and similar fees where GAAP and tax treatment were *different* (e.g., revenue vs. OID).

We recognize the questions here are lengthy and complex and likely require discussion. We would encourage you to engage further with us on these issues.

Recommendation.

As noted above, we think that the new Section 451(b) is not intended to apply to market discount or OID (if such OID is treated as discount for GAAP) and we urge you to publish guidance as soon as possible to clarify this. If such immediate and clear guidance cannot be issued, then in light of the uncertainty and questions discussed above, we would instead urge you to release transitional guidance, perhaps in the form of a Notice delaying implementation of new Section 451(b) with respect to debt instruments that have market discount and/or OID (if such OID is treated as discount for GAAP) to the first taxable year beginning on or after a date that is at least 12 months after the date the guidance resolving the uncertainties outlined above is finalized (i.e., issuance of final regulations).¹³

¹² Section 1278(a)(2)(C) (Market Discount) & Section 1273(a)(3) (OID).

¹³ We believe that keying the effective date off of fiscal (tax) years is particularly important here because, as noted above, funds have staggered year ends and a fixed effective date that may leave some funds with only weeks to implement while others have close to a year would be problematic.

Conclusion.

Thank you for considering the foregoing comments. We would be very interested in meeting with you at your earliest convenience to discuss our members' important concerns and to help in any way possible to expedite the release of needed guidance. Should you have any questions, please feel free to reach out to Payson Peabody at 202-962-7300 or at ppeabody@sifma.org; or Lindsey Keljo at 202-962-7312 or lkeljo@sifma.org.

Sincerely,



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