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Insights

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Camp Proposal to Reform Tax Treatment of Financial Products

by Michael Laveman, CPA

Taxation is a subject that is never totally out of the public spotlight, and the present is no exception. Through the efforts of its chairman Dave Camp (R- MI), the House Ways and Means Committee has focused considerable effort on tax reform generally, and in particular the revamping of the tax treatment of financial products. With control of Congress currently split between the Republicans (majority in House) and the Democrats (majority in Senate), the likelihood of any meaningful tax reform legislation becoming law in the near term would seem to be rather problematic at best. Nonetheless, Representative Camp's proposal is substantive and certainly thought provoking and represents, to a greater or lesser degree, the thinking of many influential tax policy professionals. As will be apparent, the proposal, if adopted, would have significant impact on financial service organizations, as well as buyers and sellers of financial products.

UNIFORM TAX TREATMENT OF FINANCIAL DERIVATIVES

It is safe to say that the tax rules have not kept pace with the rapid evolution of financial products and transactions. As a result, it is not uncommon under current law for economically equivalent securities or transactions to be taxed differently as to character of income (capital vs. ordinary), amount of income, timing of income and/or source. The stated goal of the Camp proposal is to bring uniformity to the tax treatment of "derivatives" (see definition below) and to more accurately measure income and loss.

To that end, under the Camp proposal, for derivatives entered into after December 31, 2013:

- All derivative positions would be marked to market at the end of each tax year, thereby being treated as if sold on the last day of the year (and immediately reacquired).
- Gains and losses from such marking to market would generate ordinary income and loss.
- For straddles (offsetting financial positions) including at least one derivative position (for example, a "mixed straddle"), all positions would be marked to market with ordinary income or loss treatment, even those not normally marked to market (such as stock and bonds).
- Special rules would apply to positions not otherwise marked to market that become part of mixed straddles. If the position has built-in gain at the time of entering into the mixed straddle, the position would be treated as if sold for its fair market value at the time of entering the mixed straddle. Proper adjustment would then be made to any gain subsequently realized with respect to such position to reflect any gain taken into account by the taxpayer by reason of the deemed sale. So, for example, if a taxpayer owned appreciated stock and wrote a call option (to generate additional income from the stock) or bought a put option (to reduce the risk of owning the stock), merely writing or buying that option would, under this proposal, cause the stock to be treated as sold for tax purposes (and immediately repurchased). Taxable gain would result, even though the stock would not have actually been disposed, with no cash generated (other than the call option premium, if applicable) to pay the tax. Further, any increase (or decrease) in the value of the stock while the option is outstanding would be "converted" into ordinary income or loss.
- If a position has a built-in loss at the time of entering into the mixed straddle, the position would not be treated as sold at the time of entering 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 built-in 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 would otherwise be recognized.

- In determining the amount of mark-to-market gain or loss on a derivative, regulatory authority would be provided so that taxpayers would be able to rely on the fair market value of derivatives that taxpayers report for financial reporting or credit purposes if value is not readily ascertainable. Also, fair market value would be determined without regard to any premium or discount based on the relative size of the taxpayer's position to the total available trading units of the instrument.
- The so-called "qualified covered call" exception to the straddle rules under current law would be repealed.
- Code Section 1256 (which generally taxes regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options and dealer securities futures contracts on a 60% long-term, 40% short-term basis) would also be repealed.
- This proposal would not apply to hedges used by companies to mitigate risk of price, currency and interest rate changes in their business operations and to certain real estate transactions (for example, options to acquire real estate).

Under this proposal, the term "derivative" is intended to be very broad; more expansive than under current rules. As defined, it would include, for example, an option, a forward or a futures contract with respect to any stock, partnership interest or debt regardless of whether the contract or interest (or the underlying contract or interest) is privately held or publicly traded. It would include most notional principal contracts (swaps), as well as short sales and short securities futures contracts. Thus, a "naked" short position in stock would be subject to mark-to-market, ordinary treatment.

Further, the term "derivative" would include generally an embedded derivative component of a debt instrument. In that case, the instrument generally would be treated as two separate instruments – a derivative subject to these rules and a debt instrument that would not. An example would be convertible debt, which would be treated as non-convertible debt (not subject to mark-to-market) and an option to acquire stock of the issuer (subject to the mark-to-market rules). A debt instrument would not be treated as having an embedded derivative component merely because it was denominated in or specified payment by reference to a nonfunctional currency, was a contingent payment or variable rate debt instrument or had an alternative payment schedule.

TREATMENT OF BUSINESS HEDGES

Under the proposal, in the case of hedging transactions entered into after December 31, 2013, taxpayers would be permitted to rely on, for tax purposes, an identification of a transaction as a hedge made for financial accounting purposes. Taxpayers would effectively be protected from inadvertent errors under the existing hedge identification tax requirements, yet would be prevented from using hindsight to identify a transaction as a hedge.

DEDUCTION FOR AMORTIZABLE BOND PREMIUM

Amortizable bond premium of an individual would be treated as an "above-the-line" deduction in determining adjusted gross income ("AGI").

Currently, it is not a deduction in determining AGI. Rather, in the case of taxable bonds, a taxpayer may elect to amortize the bond premium over the remaining life of the bond, with the premium applied against and reducing the interest income on the bond.

CURRENT INCLUSION OF MARKET DISCOUNT

The holder of a "market discount" bond (value has declined after its original issuance) acquired after December 31, 2013 would include in gross income currently the sum of the daily portions of market discount for each day during the year that the taxpayer holds the bond, computed on a constant interest rate basis. The result would be consistent with the existing tax treatment of original issue discount ("OID"). The amount included in gross income would generally be treated as interest. Currently, market discount is taken into account (absent an election to the contrary) upon the retirement of the bond or a resale of the bond by the purchaser.

However, to address market discount resulting from changes in the creditworthiness of borrowers (as distinguished from moves in interest rates), the amount of taxable market discount would be limited to the greater of (i) 5 percentage points above the bond's original yield or (ii) 10 percentage points above the applicable Federal rate ("AFR") for the bond.

Camp Proposal to Reform Tax Treatment of Financial Products *(continued)*

Brokers would be required to report includible OID and market discount to the IRS and to customers with respect to bonds acquired after December 31, 2013.

COST BASIS

For securities sold, exchanged, or otherwise disposed after December 31, 2013, taxpayers who sell a portion of their holdings in substantially identical securities would be required to determine taxable gain or loss based on the taxpayer's average cost basis in the securities, in accordance with the method currently permitted for regulated investment company ("RIC") stock. Basis would be determined on an account-by-account basis; if the taxpayer owned securities in more than one account, basis calculations would be made separately in each account.

WASH SALES

For sales and other dispositions after December 31, 2013, the proposal would expand the scope of the wash sale rule to acquisitions by certain related parties — taxpayer's spouse, dependents of the taxpayer or other taxpayers with respect to whom the taxpayer is a dependent, controlled or controlling entities and certain qualified compensation, retirement, health and education plans or accounts. In addition, the basis of any substantially identical stock or securities would not be adjusted to include the disallowed loss in the case of any acquisition by a related party other than the taxpayer's spouse. While certain related party transactions are currently addressed in IRS guidance (such as involving IRAs and Roth IRAs), this proposal would formalize by statute the broader coverage of the wash sale rule. ■

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FASB Clarifies the Liquidation Basis of Accounting

by Sean Martell, CPA and Matthew Maulbeck, CPA

In April, 2013, the Financial Accounting Standards Board issued Accounting Standards Update 2013-07, *Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting* (the "ASU"). The ASU provides guidance on when and how to apply the liquidation basis of accounting. It also sets forth key principles for the recognition and measurement of assets and liabilities and requirements for financial statements prepared using the liquidation basis of accounting.

KEY TAKEAWAYS FOR INVESTMENT FUNDS

- Liquidation basis of accounting is required when liquidation is "imminent."
- At a minimum, statements of net assets in liquidation and changes in net assets in liquidation are required.
- Assets and liabilities are measured based on estimated collection or settlement amounts; estimated costs and liabilities should be accrued through the expected liquidation date.
- New disclosures are required.
- Registered funds (1940 Act Filers) are exempt.

DETERMINATION TO BEGIN USING THE LIQUIDATION BASIS OF ACCOUNTING

In General

Financial statements should be prepared using the liquidation basis of accounting prospectively from the day liquidation is determined to be imminent. Liquidation is imminent when either of the following occurs:

1. A plan for liquidation has been approved by the person(s) with the authority to make such a plan effective, and the likelihood is remote that either the

plan will be blocked by another party or the entity will return from liquidation.

2. A plan for liquidation is imposed by other forces (i.e., involuntary bankruptcy) and the likelihood is remote that the entity will return from liquidation.

The general partner or the investment manager would typically be responsible for the approval of the liquidation plan for a hedge fund or a private equity fund.

Exceptions

Investment companies that are regulated under the Investment Company Act of 1940 (the "1940 Act") are exempt. In addition, if a plan for liquidation was specified in the governing documents at inception (i.e., a limited-life entity), the liquidation basis of accounting should only be used if the approved plan for liquidation differs from the initially specified plan. Private equity funds are typically limited-life entities, so if the private equity fund follows its governing documents when ceasing its operations, it would be exempt from applying the liquidation basis of accounting.

APPLICATION OF THE LIQUIDATION BASIS OF ACCOUNTING

The general concept underlying the liquidation basis of accounting is to report the amount of cash or other consideration that an investor might reasonably expect to receive after liquidation. As such, assets and liabilities that are recorded on the books in liquidation basis financial statements may differ from assets and liabilities that are recorded under non-liquidation GAAP (going-concern basis).

Assets shall be measured using the estimated amount of cash or other consideration that is expected to be collected in their settlement or disposition, less reasonably predictable costs of completion and disposal. This may differ from fair value as defined by U.S. GAAP. Fund managers evaluating investments under the liquidation basis of accounting should carefully consider whether fair value approximates the consideration expected to be collected as the ASU specifically states that such a presumption shall not be made.

Liabilities shall be recognized and derecognized in accordance with previously issued GAAP and adjusted to reflect changes in assumptions that are the result of the decision to liquidate (i.e., timing of payments). No assumption shall be made of being legally released as the debtor.

Costs that are expected to be incurred and income expected be earned through the end of the liquidation period should be accrued if and when there is a reasonable basis for estimation on a non-discounted basis.

All estimates should be reevaluated to determine whether they are appropriate at each reporting date.

Financial Statements and Related Disclosures

The liquidation basis of accounting requires, at a minimum, the following financial statements:

- Statement of net assets in liquidation
- Statement of changes in net assets in liquidation

Additional statements, such as a statement of cash flows or schedule of investments are not specifically addressed in the ASU. We recommend that investment funds continue to present such financial statements to the extent that they continue to be relevant.

In addition to all the disclosures required by other GAAP, at a minimum, the following should be disclosed:

1. The financial statements are prepared using the liquidation basis of accounting, including the facts and circumstances surrounding the adoption of the liquidation basis of accounting and the determination that liquidation is imminent.
2. Description of the plans for liquidation, including a description of each of the following:
   a. The manner in which it expects to dispose of its assets,
   b. The manner in which it expects to settle its liabilities, and
   c. The expected date for completion of the liquidation.
3. The methods and significant assumptions used to measure assets and liabilities including any subsequent changes to those methods and assumptions.
4. The type and amount of costs and income accrued in the statement of net assets in liquidation and the period over which those cost are expect to be paid or income earned.

FASB Clarifies the Liquidation Basis of Accounting *(continued)*

TRANSITION

The provisions of the ASU are effective when it is determined that liquidation is imminent during annual reporting periods beginning after December 15, 2013 and any interim reporting periods therein. Early adoption is permitted. The ASU should be applied prospectively. ■

Would you like more information about this content? Please contact Sean Martell (212.891.8058, sean.martell@eisneramper.com) or Matthew Maulbeck (212.891.6039, matthew.maulbeck@eisneramper.com).

IFRS for Investment Entities

by Rennie Khan, FCCA

For the first time the International Accounting Standards Board ("IASB") has issued industry specific guidance for investment entities. Under U.S. Generally Accepted Accounting Principles ("U.S. GAAP") similar guidance has existed for some time and is currently documented in Accounting Standards Codification ("ASC") 946 Financial Services-Investment Companies ("Topic 946").

One of the primary differences between a set of financial statements prepared under International Financial Reporting Standards ("IFRS") and U.S. GAAP is consolidation of controlled investee companies. This difference has resulted in an IFRS feeder fund consolidating its master fund (which it has control over) while under U.S. GAAP the master's financial statements are attached to the feeder's (investment in the master accounted for at fair value).

Investment Entities — Amendments to IFRS 10, IFRS 12 and IAS 27 (the "Guidance") (IFRS 10 – Consolidated Financial Statements, IFRS 12 – Disclosure of Interests in Other Entities, IAS 27 – Separate Financial Statements) was published in October 2012 and is required for annual periods beginning on or after January 1, 2014 (early application is permitted). The Guidance was developed due to questions raised on the usefulness of financial statements of investment entities if IFRS continued to require the consolidation of entities that an investment entity controls. The Guidance creates an exception to the principle of consolidation in IFRS 10.

The Guidance requires an investment entity (see below) to measure investments in entities that it controls at fair value through profit or loss (in accordance with IFRS 9 Financial Instruments or IAS 39 Financial Instruments: Recognition and Measurement) rather than consolidating such investments. This requirement will have a significant impact on the presentation of financial statements for master feeder structures, private equity funds and funds of funds.

An investment entity is an entity that:

(a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;

(b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and

(c) measures and evaluates the performance of substantially all of its investments on a fair value basis.

One feature that differentiates an investment entity from other entities is that it does not plan to hold its investments indefinitely; it holds them for a limited period. Because equity investments and non-financial asset investments have the potential to be held indefinitely, an investment entity shall have an exit strategy documenting how the entity plans to realize capital appreciation from substantially all of its equity investments and non-financial asset investments.

In assessing whether it meets the definition described above, an entity shall consider whether it has the following typical characteristics of an investment entity:

(a) it has more than one investment;
(b) it has more than one investor;
(c) it has investors that are not related parties of the entity; and
(d) it has ownership interests in the form of equity or similar interests.

The absence of any of these typical characteristics does not necessarily disqualify an entity from being classified as an investment entity. An investment entity that does not have all of these typical characteristics must provide additional disclosure as discussed below.

MORE THAN ONE INVESTMENT

An entity can still be considered an investment entity even though it only has one investment if the entity:

a. is in its start-up period and has not yet identified suitable investments and, therefore, has not yet executed its investment plan to acquire several investments;
b. has not yet made other investments to replace those it has disposed of;
c. is established to pool investors' funds to invest in a single investment when that investment is unobtainable by individual investors (e.g., when the required minimum investment is too high for an individual investor); or
d. is in the process of liquidation.

MORE THAN ONE INVESTOR

An entity can still be considered an investment entity even though it only has one investor if it:

a. is within its initial offering period, which has not expired and the entity is actively identifying suitable investors;
b. has not yet identified suitable investors to replace ownership interests that have been redeemed; or
c. is in the process of liquidation.

UNRELATED INVESTORS

An entity may still qualify as an investment entity even though its investors are related to the entity. For example, an investment entity may set up a separate 'parallel' fund for a group of its employees (such as key management personnel) or other related party investor(s), which mirrors the investments of the entity's main investment fund. This 'parallel' fund may qualify as an investment entity even though all of its investors are related parties.

DISCLOSURE REQUIREMENTS

Because a consolidated investee set of financial statements contains more disclosures than one shown at fair value, the Guidance has introduced the following disclosure requirements:

(a) An entity shall disclose that it meets the definition of an investment entity and the significant judgments and assumptions it has made in determining it is an investment entity.
(b) When an entity becomes, or ceases to be, an investment entity, it shall disclose the change of investment entity status and the reasons for the change.
(c) For each unconsolidated subsidiary, an investment entity shall disclose:
   1. the subsidiary's name;
   2. the principal place of business (and country of incorporation if different from the principal place of business) of the subsidiary; and
   3. the proportion of ownership interest held by the investment entity and, if different, the proportion of voting rights held.
(d) An entity shall disclose the nature and extent of any significant restrictions (e.g., resulting from borrowing arrangements, regulatory requirements or contractual arrangements) on the ability of an unconsolidated subsidiary to transfer funds to the investment entity in the form of cash dividends or to repay loans or advances made to the unconsolidated subsidiary by the investment entity.
(e) An entity shall disclose any current commitments or intentions to provide financial or other support to an unconsolidated subsidiary, including commitments or intentions to assist the subsidiary in obtaining financial support.
(f) An investment entity shall disclose the terms of any contractual arrangements that could require the entity or its unconsolidated subsidiaries to provide financial support to an unconsolidated, controlled, structured entity, including events or circumstances that could expose the reporting entity to a loss (e.g., liquidity arrangements or credit rating triggers associated with obligations to purchase assets of the structured entity or to provide financial support).

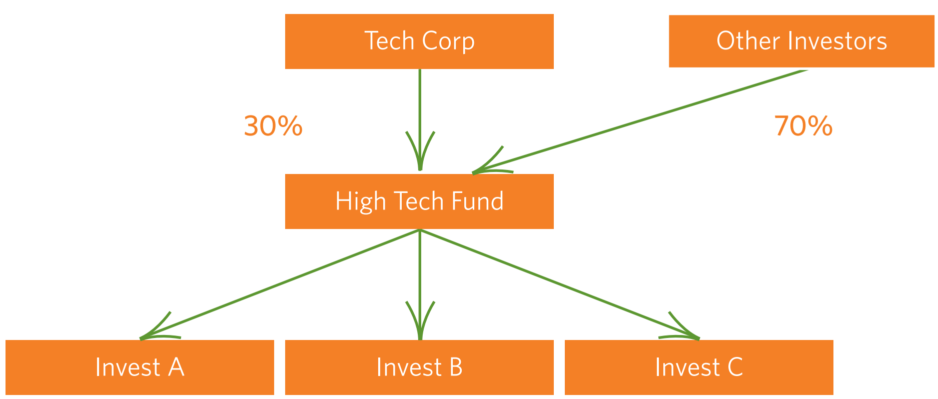
IFRS for Investment Entities
(continued)

DETERMINING IF AN ENTITY IS AN INVESTMENT ENTITY

EXAMPLE 1

Purpose	Invest in entities with rapid growth potential with the objective of realizing capital appreciation.
Investments	Controlling interest in one entity acquired in Year 2 of operations. Other investments made in Year 3
Reporting	Fair value basis, provided to the general partner and investors.
Exit Strategy	Dispose of investee and distribute cash or shares to investors.
Investment Entity?	Yes – from inception

EXAMPLE 2 — High Tech Fund



Purpose	Invest in technology start-up companies for capital appreciation.
Scenario	Tech Corp holds options to acquire Invest A/Invest B/Invest C, at fair value, if the technology developed by A, B or C would benefit the operations of Tech Corp.
Exit Strategy	None currently reported.
Investment Entity?	No — because the options provide a benefit in addition (i.e., the technology of the **Investment** investee companies) to capital appreciation or investment income and no exit strategy exists.

Note that the Guidance says the required disclosure may be provided by including, in the financial statements of the parent, the financial statements of the subsidiary that contains the information, however this is not a requirement. Therefore if a feeder's financial statements contain all the required disclosures it does not have to attach the master's, however attaching the master's may be the easiest option.

EXCEPTION TO THE RULE

If an investment entity has a subsidiary that provides investment related services, such as investment management services, to the entity or other parties, the investment entity must consolidate this subsidiary.

EARLY ADOPT?

If an entity is considering whether to early adopt the Guidance, the following should be taken into account:

1. If it is early adopted all the requirements of the Guidance need to be adopted and not just selected sections that will be of benefit to the entity.
2. As this is an amendment to IFRS 10 and IFRS 12, if the Guidance is early adopted, IFRS 10 and IFRS 12 will also have to be adopted (IFRS 11 Joint Arrangements would also have to be early adopted as IFRS 10, 11 and 12 go together, however IFRS 11 is very rarely encountered for investment entities).
3. Although there is no requirement to attach the master's financial statements to the feeder's, this might be the best solution if there are multiple feeders into the master, in order to meet the risk disclosure requirements of IFRS 7 Financial Instruments: Disclosures.

CONCLUSION

Currently, the marriage of IFRS and U.S. GAAP has been postponed due to the findings of the "Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers," however, the Guidance represent a huge step forward for comparing the financial statements of hedge funds prepared under IFRS and U.S. GAAP.

In June 2013, the Financial Accounting Standards Board issued Accounting Standards Update 2013-08, *Financial Services — Investment Companies (Topic 946) — Amendments to the Scope, Measurement and Disclosure Requirements* ("ASU 2013-08"). ASU 2013-08 clarifies the characteristics of an investment company, and provides comprehensive guidance for assessing whether an entity is an investment company. It also requires additional disclosures for entities that are classified as an investment company, similar to the disclosures noted above. ■

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