September 10, 2024

Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Comments on 2024 Proposed Regulations Identifying Certain Basket Contract Transactions as Listed Transactions

I. Introduction

On behalf of the North American Tax Working Group ("NATWG") of the International Swaps and Derivatives Association, Inc. ("ISDA"),[1] I am writing in support of the comments submitted by the Securities Industry and Financial Markets Association ("SIFMA") in its letter dated September 10, 2024 (the "SIFMA Letter") on the 2024 proposed regulations identifying certain "basket contract" transactions as "listed transactions" (the "Proposed Regulations").[2]

We also refer to our letter to the U.S. Treasury Department ("Treasury") dated September 18, 2020, containing comments on the treatment of the modification of non-debt derivatives under Section 1001 (the "ISDA Derivative Modification Letter"), a topic relevant to the Proposed Regulations as discussed below.[3]

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[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 76 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

[2] Identification of Basket Contract Transactions as Listed Transactions, NPRM REG-102161-23, Jul. 12, 2024. The designation of a transaction as a listed transaction has multiple consequences, including that participants in, and material advisors with respect to, the transaction are required to file disclosures with the Internal Revenue Service (the "IRS") or be subject to substantial penalties. *See* Sections 6011, 6111, 6707, 6707A and the regulations thereunder.

References to "Sections" herein are references to sections of the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury Regulations promulgated thereunder.

[3] The ISDA Derivative Modification Letter is attached hereto as Exhibit A.

In addition to endorsing the recommendations made in the SIFMA Letter, the NATWG would like to emphasize certain points of particular importance to the derivatives market.

II. General Concerns: The Proposed Regulations would apply to many non-abusive transactions, would inappropriately take the place of substantive guidance and would generate compliance burdens and uncertainty for taxpayers

The Proposed Regulations follow two 2015 notices released by Treasury that designated certain "basket options" as listed transactions and certain "basket contracts" as "transactions of interest" (collectively, the "Basket Notices").[4] The Basket Notices apply to contracts referencing certain underlying assets where the taxpayer, or its "designee," exercises discretion to change the underlying reference assets or algorithm, subject to exceptions. Although basket options were already listed transactions under the Basket Notices, the Proposed Regulations have a meaningful impact on taxpayers because they elevate the significantly broader of the two categories – basket contracts – to listed transaction status.

Listed transaction status means that participants in, and material advisors to, a potentially in-scope transaction may be subject to substantial penalties as well as significant reputational risk. The category of listed transactions is intended to encompass abusive transactions that are subject to disallowance under current law, not ordinary business transactions.[5] However, as drafted, the Proposed Regulations are broad in scope and unclear in many respects. Consequently, they potentially apply to many non-tax motivated transactions. They can also apply to many transactions that are not – at least under any clear governing authority – subject to disallowance under current law. They therefore deviate significantly from the policies underlying the reportable transaction regime applicable to listed transactions.

In particular, the Proposed Regulations potentially apply to derivatives and other investment contracts that reference indices on publicly traded securities and other publicly traded financial assets. These indices may be managed by third parties unrelated to, and independent of, the taxpayer or the counterparty to the contract. While these indices may be thematic and/or rules-based, they may have elements of discretion that do not clearly meet the specifically permitted discretion set forth in the Proposed Regulations. For example, such indices may rely on commercially available corporate ratings (e.g., relating to environmental, social or governance ("ESG") factors or financial strength) in order to establish the universe of reference assets to which the index is linked, and the providers of these ratings may employ some discretion in their determinations. Moreover, for various reasons, these derivatives and indices might not

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[4] Notice 2015-73, 2015-46 I.R.B. 660; Notice 2015-74, 2015-46 I.R.B. 663.

[5] *See*, *e.g.*, 149 Cong. Rec. S. 10533, 10558 (Senate Finance Committee Print of the Technical Explanation of the Energy Tax Incentives Act of 2003, discussing new Section 6707A) ("The first category is any transaction that is the same as (or substantially similar to) a transaction that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a "listed transaction")); Ann. 2000-12, 2000-12 IRB 1 ("The Treasury and the Service have determined that each of those listed transactions involves a significant tax avoidance purpose and that the intended tax benefits are subject to disallowance under existing law").

– at least clearly – qualify for exceptions to reporting under the Basket Notices and Proposed Regulations, such as the exception for indices that are "widely used and publicly quoted" and "based on objective financial information." In some cases, this is because the indices may involve considerations such as ESG factors that potentially do not qualify as "objective financial information" – a term that is undefined in the Basket Notices and the Proposed Regulations. In other cases, it may be difficult to determine whether an index is "widely used," another term that is not defined.

Such indices, and the derivative and other investment contracts that reference them, serve a valuable investment function for their users. Furthermore, discretionary elements of the type described above do not present the concerns underpinning the Basket Notices. In fact, these transactions are very different from the paradigm transaction that motivated the Basket Notices: a purported derivative contract that, in reality, represented beneficial ownership by the taxpayer of the underlying assets because the taxpayer received the economic return on a unique basket and actively controlled its composition.[6] Derivatives determined by reference to publicly available indices linked to objective prices of publicly traded assets do not typically implicate these tax ownership concerns and therefore do not pose the central type of abuse targeted by the Basket Notices.

These transactions can pose the technical questions that were the subject of the ISDA Derivative Modification Letter, namely the issue of when modifications to the terms of non-debt financial contracts result in a taxable event under Section 1001. As discussed in the ISDA Derivative Modification Letter, Treasury and the IRS have yet to issue substantive guidance on this topic, and little relevant case law or other authority exists. We provided a number of specific recommendations for guidance as to circumstances in which modifications to underlying assets or indices should not result in a taxable event under Section 1001. We respectfully reiterate these recommendations, as we believe that substantive guidance, rather than reportable transaction reporting, is the best way to provide certainty to taxpayers and the IRS on this topic without deterring non-tax motivated investment transactions.

As the ISDA Derivative Modification Letter expressed with respect to the Basket Notices, the Proposed Regulations can be expected to impose an ongoing and substantial burden on financial institutions. This burden exists because institutions that issue structured notes or execute other derivatives, in either case referencing more than one underlying asset, would be required to make determinations regarding whether such transactions are subject to listed transaction reporting under the Proposed Regulations. Given the breadth of the Proposed Regulations, the narrowly-circumscribed exceptions, and the presence of undefined terms such as "widely used," "objective financial information," "broad market," and "market segment," there is significant uncertainty in how these rules should be applied. Accordingly, such determinations can take substantial time and resources even in the context of ordinary business transactions.

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[6] *See* Notice 2015-73 ("The Treasury Department and the [IRS] are aware of a type of structured financial transaction, described [in Section 1 of the Notice], in which a taxpayer attempts to defer income recognition and convert short-term capital gain and ordinary income to long-term capital gain using a contract denominated as an option contract...The IRS may assert one or more arguments to challenge the parties' tax characterization of a basket option contract, including: (1) that C, in substance, holds the assets in the reference basket as an agent of T and that T is the beneficial owner of the assets for tax purposes…").

The treatment in the Proposed Regulations of all in-scope transactions as listed transactions along with the broadening of this scope to include "substantially similar" transactions within the meaning of Treasury Regulations Section 1.6011-4(c)(4), as discussed further below, will significantly exacerbate this effect and deter taxpayers from entering into legitimate, non-abusive transactions.

Further, as noted by SIFMA, the Proposed Regulations impose substantial retroactive filing requirements that are likely to be a significant burden for taxpayers, in that they apply to transactions in years prior to the date of publication of finalized regulations for which the period of limitations for assessment of tax has not ended. For transactions that were already reported under Notice 2015-74, a requirement to file again represents an unnecessary and duplicative requirement because the IRS already has the same information about these transactions as would be required under the Proposed Regulations. Beyond those transactions, because the Proposed Regulations are somewhat more open-ended in scope than the Basket Notices, as discussed below, and because the "listed transaction" rules can encompass certain transactions not required to be reported under the "transaction of interest" category, financial institutions and other market participants will be required to undertake a costly and difficult effort to identify and evaluate long-ago transactions that were determined at the time not to be reportable transactions but might now conceivably be in scope for retroactive reporting. And because many financial institutions and tax return preparers have policies prohibiting the entry into a listed transaction, the retroactive designation of a transaction as a listed transaction may result in the inadvertent violation of these policies, with adverse consequences to these institutions as well as to taxpayers, even though the participants and advisors to the transaction followed the then-outstanding guidance in the form of the Basket Notices.

III. Specific recommendations for narrowing and clarifying the scope of the Proposed Regulations

Assuming the Proposed Regulations' general approach is retained, the NATWG agrees with the SIFMA Letter that the Proposed Regulations should be substantially narrowed and clarified to ensure that they capture only transactions that are abusive and do not deter taxpayers from entering into ordinary investment transactions out of fear that the reporting regime might apply. The NATWG would like to emphasize the following recommendations in particular:

A. Scope of "substantially similar"

The NATWG reiterates the recommendation expressed in the SIFMA Letter that the "substantially similar" standard in the Proposed Regulations should be replaced by the limiting language from the Basket Notices that a transaction would only be "substantially similar" to the transaction identified in the relevant Notice if the transaction met specified criteria. The ambiguity as to what constitutes a transaction with "the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy [to the basket contract listed transaction]," along with the principle under Treasury Regulations Section 1.6011-4(c)(4) that "substantially similar" be construed broadly, will increase the expense and difficulty faced by market participants in evaluating non-abusive transactions. As it is, taxpayers have already found it challenging to interpret the scope of the Basket Notices in many cases. Accordingly, absent specific criteria, the "substantially similar" standard in Proposed Regulations

expands the already uncertain universe of in-scope transactions while making the precise boundaries of this expanded universe less clear. In addition, as noted above, this scope expansion makes compliance with the retroactive reporting requirement extremely challenging.

B. Definition of designee

The NATWG similarly echoes the recommendation in the SIFMA Letter that the definition of "designee" whose exercise of discretion results in application of the Proposed Regulations should be narrowed. In particular, the "selected by" prong of the definition of "designee" should be replaced with a narrower "acting in concert" requirement. There should be a meaningful relationship between the taxpayer receiving the tax benefit and the party modifying the reference basket. Including any party "selected by" the taxpayer to suggest, request, or determine changes in the reference basket or trading algorithm without a limiting principle could, in its broadest interpretation, include a calculation agent or index sponsor with which the taxpayer has no significant connection, merely because the contract designates that person as responsible for making certain determinations.

The NATWG also recommends limiting the "compensated by" prong to exclude circumstances where an index, rating or other market measure is generally available to market participants on commercial terms, such as through a license or similar arrangement, and therefore is not unique to the taxpayer. Such arrangements do not implicate the concerns motivating the Basket Notices and the Proposed Regulations because the taxpayer has no influence on the determinations made, notwithstanding that the index sponsor or other similar provider may receive compensation (typically from the counterparty).

C. Scope of discretion

As with the SIFMA Letter, the NATWG is concerned about the impact of the Proposed Regulations on market participants' ability to link derivatives to "thematic" indices – that is, indices based on certain predetermined themes or criteria, the maintenance of which may involve some level of subjectivity, such as indices based on ESG factors or indices that are intended to comply with Shariah law. The uncertainty under the Basket Notices regarding (i) whether the index committee for such an index might be a "designee" and (ii) whether such themes or criteria are sufficiently objective to avoid causing the taxpayer to be treated as exercising discretion when the associated indices are administered has limited the market for such derivatives.

In the context of the Proposed Regulations, the NATWG agrees with the recommendation in the SIFMA Letter that "discretion" should not be found to exist where an index has a theme that is based on rules determined at the inception of the contract and changes consistent with such rules are made to the basket in order to maintain exposure consistent with that theme.

As an alternative to expanding the universe of permissible types of discretion, Treasury and the IRS could exclude derivatives that reference these indices from reporting by expanding and/or clarifying existing exceptions to the definition of "designee" in the Proposed Regulations. For example, the exception applicable in respect of indices tracking a broad market or market segment could be clarified as including indices

tracking a clearly stated and consistently followed theme, even if there may be elements of discretion in the determinations necessary for the relevant administrator or calculation agent to follow that theme. Treasury could also exclude many of these derivatives from reporting by expanding and/or clarifying the exception for "widely used and publicly quoted" indices to permit non-financial inputs (e.g., a company's annual emissions of carbon dioxide) that are obtainable from public sources.[7]

D. Contracts with resets

The NATWG also concurs with and echoes the proposition in the SIFMA Letter that the Proposed Regulations should exclude contracts that have a term of one year or less or have a reset at least annually, where a "reset" is defined as a payment event pursuant to which all gains and losses on the referenced underlying property for the relevant period are taken into account in determining the amount of such payment. As described in the SIFMA Letter, contracts with these features would not present the opportunity for material deferral or conversion into long term capital gain.

In the case of notional principal contracts specifically, the tax accounting rules under Treasury Regulations Section 1.446-3 regarding periodic payments would, in any event, require a taxpayer to recognize, as ordinary income or a deduction, an amount based on the increase or decrease in value of any index as of the end of the year where the corresponding payment is not determined or made until the next year.[8] Accordingly, notional principal contracts that provide solely for annual (or more frequent) periodic payments do not present the opportunity for deferral or conversion of income and should be excluded from the Proposed Regulations.

E. Reliance on taxpayer representations and forms

Under the Proposed Regulations, with respect to a counterparty "C," a transaction is not the same as or substantially similar to a basket contract transaction if the taxpayer represents to C in writing under penalties of perjury that none of the taxpayer's returns for taxable years ending on or after January 1, 2011 has reflected or will reflect a tax benefit with respect to the transaction.

The NATWG reiterates the observation in the SIFMA Letter that (i) to the extent the concern is the taxpayer's inaccurate reporting, the taxpayer's own returns are already subject to penalties of perjury, and (ii) the "penalties of perjury" language could in practice lead parties to abandon ordinary commercial transactions that have no potential for tax abuse. We observe that, as permitted by Treasury Regulations, market

[7] We observe that, if the recommendations made in the SIFMA Letter, and echoed in Section III.B above, regarding narrowing the definition of "designee" are accepted, derivatives referencing many of these thematic indices would be exempt from reporting because the indices are generally available for licensing or are themselves based on ratings or other metrics that are similarly available.

[8] Treasury Regulations Section 1.446-3(e)(2).

participants already rely for tax withholding purposes on counterparty representations that are not made under penalties of perjury.[9]

Relatedly, the NATWG echoes the SIFMA Letter's recommendation that, for purposes of providing a reporting exception to counterparty "C" with respect to C's transactions with non-U.S. taxpayers, Forms W-8IMY and W-8EXP should be allowed in addition to Forms W-8BEN and W-8BEN-E, assuming the relevant form demonstrates that the party providing it is not a U.S. taxpayer with respect to the transaction. In this regard, the Basket Notices allowed a Form W-8EXP to be provided for this purpose, whereas the Proposed Regulations do not. The preamble to the Proposed Regulations does not indicate the reason for this change, and the NATWG is unaware of any policy reason for the change.

IV. ***Conclusion***

For all of the foregoing reasons, the NATWG agrees with the SIFMA Letter's recommendations and emphasizes the recommendations described above as of particular importance to the derivatives industry.

Thank you for your consideration of these concerns. We would be pleased to discuss any aspect of this letter with you further.

Yours truly,

Maureen Smith

[9] Treasury Regulations Section 1.1441-4(a)(3)(ii) provides that amounts attributable to notional principal contracts shall not be treated as effectively connected with the conduct of a trade or business within the United States if the payee provides a representation in an ISDA Agreement that the payee is a U.S. person or a non-U.S. branch of a foreign person. Such representation is not required to be made under penalties of perjury.

Exhibit A – ISDA Derivative Modification Letter

[enclosed]

ISDA® Safe, Efficient Markets

September 18, 2020

The Honorable David Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220

Comments on the Treatment of the Modification of Non-Debt Derivatives Under Section 1001

Dear Mr. Kautter:

I am writing on behalf of the North American Tax Committee ("NATC") of the International Swaps and Derivatives Association ("ISDA").[1] On August 15, 2016, the Treasury Department ("Treasury") released its Priority Guidance Plan for 2016-2017. One of the items included in the plan under the Financial Institutions and Products heading was: "Regulations under §1001 on the modification of nondebt financial instruments."[2] We welcome the government's efforts to bring clarity to an area that has been in need of guidance for many years and are pleased to submit our thoughts on the regulation project.

While Treas. Reg. § 1.1001-3 provided comprehensive guidance regarding the treatment of debt modifications more than 20 years ago, little authority exists regarding the treatment of the modification of non-debt derivatives (referred to hereinafter as "derivatives"). This has created substantial uncertainty in the derivatives market, and such uncertainty has impacted the willingness of many taxpayers to engage in otherwise desirable modifications of their derivatives.

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1 Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 925 member institutions from 75 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

2 Although Treasury did not include this item in its more recent Priority Guidance Plans, we understand its omission reflects the fact that this matter is a longer-term project, and not that the government has abandoned its efforts to address this subject.

International Swaps and Derivatives Association, Inc.
10 East 53rd Street, 9th Floor
New York, NY 10022
P 212 901 6000 F 212 901 6001
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

Guidance on this topic is particularly important to investment funds and other non-dealers that enter into or acquire derivatives as part of their business or investment activities. While the occurrence of a deemed exchange of a derivative may be less critical to a dealer that is a party to a derivative (because of the requirement for dealers in derivatives to mark such positions to market under section 475), deemed exchange treatment is of significant interest to the dealer community as well.[3]

We fully support the government's efforts to provide much-needed guidance in this area and, as described in detail below, strongly encourage the government, where possible, to use bright-line tests or safe harbors regarding when a derivative modification will result in a deemed exchange. The promulgation of clear rules governing this topic is desirable both (i) to enable taxpayers to execute modifications desirable from a business standpoint without experiencing undue tax risk and (ii) to discourage taxpayers from inappropriately interpreting the lack of authority to their benefit.

A. Background

1. The Code and Regulations

Section 1001(c) states that, except as otherwise provided, "the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized." Under section 1001(a), gain or loss from the "sale or other disposition of property" is the difference between the amount realized (as defined in section 1001(b)) and the adjusted basis for the property (as provided in section 1011). Treas. Reg. § 1.1001-1(a) provides that: "Except as otherwise provided . . ., the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained." Thus, in the absence of guidance, in the case of a transaction to which section 1001 applies, whether a modification ordinarily results in a deemed exchange is determined based on whether the modified instrument differs materially in kind or extent from the unmodified instrument.

Following the Supreme Court's decision in *Cottage Savings*,[4] many practitioners were concerned about the threshold for triggering a realization event under the

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[3] For example, in the case of a derivative referencing a U.S. equity security, whether a derivative modification results in a deemed exchange of the derivative can affect whether section 871(m) will apply to cause U.S. withholding tax to be imposed with respect to the derivative. Specifically, while a notional principal contract or equity linked instrument issued prior to January 1, 2017 generally is not subject to withholding under section 871(m), a deemed exchange under section 1001 of a pre-effective date derivative may cause such a derivative to be subject to section 871(m) withholding after the modification. Furthermore, if section 871(m) will apply to non-delta one derivatives meeting either the delta threshold or the substantial equivalence test (as proposed under Treas. Reg. § 1.871-15), a deemed reissuance of a derivative that originally did not meet either test may cause the reissued derivative to be subject to section 871(m) withholding after the modification due to a re-testing of the derivative.

[4] 499 U.S. 554 (1991). In *Cottage Savings*, the taxpayer engaged in exchanges of pools of residential mortgages for different pools of residential mortgages and, in each case, claimed a tax loss. Although the mortgage pools were substantially similar from an economic perspective, the pools contained mortgages from different borrowers and were secured by different properties. The

"materially different" standard in connection with debt modifications and the possibility that such threshold might be lower than previously believed. The government, recognizing that uncertainty existed, proposed regulations under Treas. Reg. § 1.1001-3 in 1992 and finalized those regulations (the "Debt Modification Regulations") in 1996 to address the modification or exchange of debt instruments. While Treas. Reg. § 1.1001-3 provides wide-ranging guidance addressing when an alteration to the terms of a debt instrument results in a deemed exchange for the instrument, it did not provide guidance with respect to the treatment of derivative modifications. The preamble to the final Debt Modification Regulations, however, stated:

> for contracts that are not debt instruments, the final regulations do not limit or otherwise affect the application of the "fundamental change" concept articulated in Rev. Rul. 90-109 (1990-2 C.B. 191), in which the IRS concluded that the exercise by a life insurance policyholder of an option to change the insured under the policy changed "the fundamental substance" of the contract, and thus was a disposition under section 1001.[5]

The only formal guidance addressing derivative modifications is contained in Treas. Reg. § 1.1001-4 (concerning the treatment of certain assignments of derivatives) and Prop. Reg. § 1.1001-6 (addressing the modification of derivatives to implement a change from an interbank offered rate to an alternative rate). Thus, other than in the limited case of an assignment governed by Treas. Reg. § 1.1001-4, the standard for determining whether there is a realization event upon an alteration to the terms of a derivative appears to be whether there has been an exchange of such property for cash or "other property differing materially either in kind or in extent," although the preamble to the final Debt Modification Regulations (and certain other government pronouncements) might be read to suggest that the relevant standard is whether the modification resulted in a change to the "fundamental substance" of the derivative.

2. Basket Notices

In 2015, the Internal Revenue Service (the "Service") issued two Notices (collectively, the "Basket Notices")[6] identifying certain types of derivative transactions relating to baskets of assets as either listed transactions or transactions of interest (within the meaning of Treas. Reg. § 1.6011-4).[7] Notice 2015-73 identifies transactions that it refers to as "basket option contracts" and any substantially similar transactions as "listed transactions." Notice 2015-74 identifies transactions that it refers to as "basket contracts"

Supreme Court held that whether two properties differ materially in kind or extent turned on whether the properties represented legally distinct entitlements, not on whether they were economic equivalents.

5 1996-2 C.B. 61.

6 Notice 2015-73, 2015-46 I.R.B. 660, and Notice 2015-74, 2015-46 I.R.B. 663, replacing Notice 2015-47, 2015-30 I.R.B. 76, and Notice 2015-48, 2015-30 I.R.B. 77, respectively.

7 Treas. Reg. § 1.6011-4(a) generally requires taxpayers to disclose their participation in "reportable transactions," including transactions identified as listed transactions and transactions of interest. *See* Treas. Reg. § 1.6011-4(b)(2) and (6).

and any substantially similar transactions as "transactions of interest." The transactions subject to reporting under each of the Basket Notices have the following common features: (i) the taxpayer ("T") enters into a transaction that is denominated as a derivative contract; (ii) T or T's "designee" has exercised discretion to change the assets in the reference basket or the trading algorithm; and (iii) T's tax return for a taxable year ending on or after January 1, 2011 reflects a "tax benefit."

Notice 2015-73 states that, among other arguments that the IRS may assert to challenge the taxpayer's position, the IRS may assert "that changes to the assets in the reference basket during the year materially modify the basket option contract and result in taxable dispositions of the contract under § 1001 throughout the term of the contract." Similarly, Notice 2015-74 provides that in "appropriate situations," the IRS may challenge the taxpayer's position that changes to the assets in a basket do not result in a deemed exchange under section 1001.

The Basket Notices impose an ongoing and substantial burden on financial institutions. This burden exists because institutions that issue structured notes or execute other derivatives, in either case referencing more than one underlying asset, must make a determination regarding whether such transactions are subject to reportable transaction reporting under the Basket Notices. Additionally, the Basket Notices create some ambiguity concerning their applicability to certain ordinary course, commercial, non-tax motivated transactions. While the Basket Notices provide a number of helpful exclusions (many of which are discussed below), the process for determining whether an exclusion applies, and reporting transactions where no exclusion is available, is burdensome. The Basket Notices appear to be targeted at transactions where, due to the lack of guidance concerning derivative modifications, a taxpayer may take the position that a change to a reference pool of assets does not result in a deemed exchange under section 1001 of the derivative referencing that pool. Once clear guidance is provided regarding when such changes result in a deemed exchange of the relevant derivative, reporting of such transactions under Treas. Reg. § 1.6011-4(a) should no longer be needed. Consequently, we recommend that the issuance of regulations addressing derivative modifications be accompanied by a revocation of the Basket Notices.

B. Summary of Recommendations

The following is a brief summary of the recommendations made in this letter with respect to any regulations promulgated to address derivative modifications (the "Regulations"):

- As under the Debt Modification Regulations, we recommend that the Regulations should find a deemed exchange for purposes of section 1001 only where the instrument is "modified" and the modification of the instrument is "significant."

- We recommend that the Regulations generally define a "modification" in the same manner as defined under the Debt Modification Regulations, but with exceptions for the following types of alterations:

- changes to an index or basket (or the components thereof) in a manner determined entirely pursuant to a formula or algorithm,
- changes to an index that either is widely used and publicly quoted or tracks a broad market or market segment,
- changes to a derivative pursuant to a unilateral option, except where the taxpayer or its designee has the right to, and does in fact, change the assets referenced by the derivative,
- changes that occur due to the exercise of routine judgment, including routine judgment that is specifically contemplated by the original terms of the instrument or is exercised pursuant to a pre-determined standard (other than a standard that is principally focused on the financial performance of the index constituents),
- changes made to correct errors made by the parties in the documentation of a derivative,
- changes that occur pursuant to the terms of a derivative, and
- an increase or decrease in the notional amount of a derivative.

- We recommend that the Regulations clearly identify when an exercise of discretion to modify a basket will constitute a modification of a derivative referencing such basket.

- Our recommendations regarding what modifications should be treated as "significant" are as follows:
  - The rule under Treas. Reg. § 1.1001-4 providing for tax-free treatment of assignments of derivatives should be preserved, but the second requirement (*i.e.*, that the terms of the derivative contract permit the assignment) for such tax-free treatment should be eliminated.
  - Changes to the security or credit enhancement for a derivative should not constitute a significant modification unless such changes result in a change in payment expectations.
  - Where the asset or assets referenced by a derivative change in a manner that is not excluded from modification treatment, such changes generally should result in a significant modification except where (i) the asset referenced by the modified derivative is expected to perform economically in a manner that is substantially identical to the asset referenced by the original derivative, and (ii) the changes to a basket referenced by a derivative within a particular period of time are insignificant.

- Either (i) the extension of the term of a total return swap should not be considered a significant modification or (ii) if such an extension may be considered a significant modification, a safe harbor similar to that contained in the Debt Modification Regulations should be provided.

- A change to the spread from the benchmark rate should not constitute a significant modification unless the change exceeds a safe harbor amount.

- Alterations to the frequency of rate resets should not be treated as significant modifications.

C. Discussion

1. Overall Approach

Before providing detailed recommendations regarding the drafting of the Regulations, we set forth immediately below general comments that we believe should be considered in approaching this project.

First, we believe that the Debt Modification Regulations provide a useful starting point for purposes of crafting the Regulations. The Debt Modification Regulations find a deemed exchange for purposes of section 1001 only where (i) the debt instrument is "modified" and (ii) the modification of the instrument is "significant." The concept of a "significant modification" being the touchstone for a deemed exchange is well understood and has proven useful in the context of debt modifications. As a result, we recommend that the Regulations use the same or similar construct in determining whether a derivative modification results in a deemed exchange of the existing derivative for a new derivative.

We also recommend that the Regulations incorporate the "economic significance" standard used in the Debt Modification Regulations into the Regulations. In particular, the Regulations should make clear that a modification to the terms of a derivative does not result in a deemed exchange if the modification either (i) does not affect the economic terms of the derivative or (ii) affects such economic terms in a manner that is insignificant. For example, if an option that can be (or must be) physically settled is modified to require cash settlement, such a change does not affect the economic profile of the parties to the transaction, and therefore should not result in a deemed exchange (even though it will (or at least might) affect the manner of payment). To allow changes that are not economically significant to trigger deemed exchanges would enable exactly the kind of "hair trigger" deemed exchanges (*i.e.*, those that are undertaken with an intention to trigger built-in gain or loss in the derivative without a meaningful change to its terms) that the government should seek to prevent. By employing an economic significance standard and providing safe harbor provisions for certain types of modifications, the Debt Modification Regulations generally do not permit the parties to a debt instrument to trigger intentionally a deemed exchange without an economically meaningful change to the terms of the instrument. The same hurdle to a volitional trigger of a deemed exchange should exist with respect to derivative modifications.

Nevertheless, while the Debt Modification Regulations may be a helpful starting point in providing a framework for, and in drafting certain of the provisions to be incorporated in, the Regulations, the government should consider the important differences between debt instruments and derivatives in designing the Regulations.

Furthermore, where relevant, the government should also take into account the potential importance of the different features present in different classes of derivatives. For example, and as discussed below, in certain circumstances, a change to the terms of a call option may be more or less meaningful than a similar change to the terms of a total return swap.[8]

Lastly, our recommendations below should not be viewed as a statement regarding whether a particular type of change to a derivative would or would not result in a deemed exchange of such derivative under existing law. Such recommendations instead represent the views of the NATC regarding how to draft rules that are both administrable and minimize the occurrence of results that would be inappropriate.

2. Determining What Changes Are "Modifications"

As described above, we believe that an alteration of a derivative should not result in a deemed exchange unless such alteration is considered a "modification" of the terms of the derivative. Subject to certain exceptions, the Debt Modification Regulations generally define a "modification" as "any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise."[9] We believe that this definition would be a good starting point for defining the term "modification" in the Regulations.

We note, however, that certain events have the effect of causing an alteration to the economic profile of a derivative without changing the specific terms of the derivative. Specifically, where a derivative references an index or basket of assets, each change to the index or basket can change the financial results to the parties to the derivative. For the reasons described below, we believe that many of such index or basket adjustments should not rise to the level of being considered a modification of a derivative referencing such index or basket, and thus exceptions from deemed exchange treatment should be provided for such adjustments. Nevertheless, where such an exception does not apply, we believe that an index or basket adjustment should be considered an alteration to the terms of a derivative referencing the index or basket (even where the terms of the derivative have not themselves changed), and thus should trigger a deemed exchange of the derivative if the alteration is significant and no other exception applies.

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8 While much of the discussion in this letter focuses on delta one instruments, except as otherwise indicated, our recommendations below are intended to apply to both delta one derivatives and non-delta one derivatives.

9 Treas. Reg. § 1.1001-3(c)(1)(i).

a. Treatment of Changes Pursuant to an Instrument's Terms Generally

The Debt Modification Regulations provide that, subject to certain exceptions, "an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument" is not a "modification," and thus will not result in an exchange for purposes of section 1001.[10] However, an alteration occurring by operation of the terms of a debt instrument is nevertheless considered to be a modification if such alteration:

- results in an instrument that is not debt,
- occurs pursuant to certain options,
- results in the substitution of a new obligor or the addition or deletion of a co-obligor, or
- results in a change (in whole or in part) in the recourse nature of the instrument (from recourse to nonrecourse or from nonrecourse to recourse).

The preamble to the final Debt Modification Regulations explains these exceptions by stating that "these changes may be so fundamental that they should be considered modifications even if they occur by operation of the terms of an instrument."[11]

The principle that an alteration that occurs automatically or pursuant to the exercise of an option existed in the tax law for decades before the Debt Modification Regulations were promulgated.[12] This principle is based on the belief that the property that exists after the automatic or optional change is the same property that existed before the change; the property always had the potential for such a change, and the parties had agreed to permit the change as part of its original agreement. For this reason, it is not surprising that the Debt Modification Regulations followed this principle by generally exempting from modification treatment changes to a debt instrument that occur automatically or pursuant to certain options. It also is not surprising that such regulations put limits on this exclusion by providing that certain types of changes must be viewed as modifications even if occurring pursuant to the terms of the instrument.

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10 Treas. Reg. § 1.1001-3(c)(1)(ii). The regulations provide that such an "operation of the terms" change may occur "automatically (for example, an annual resetting of the interest rate based on the value of an index or a specified increase in the interest rate if the value of the collateral declines from a specified level)" or "as a result of the exercise of an option provided to an issuer or a holder to change a term of a debt instrument." Treas. Reg. § 1.1001-3(c)(1)(ii).

11 T.D. 8675.

12 *See, e.g.*, Rev. Rul. 57-535, 1957-2 C.B. 513 (holders of nonmarketable Treasury bonds with a 2.75 percent coupon recognized no gain or loss upon exchange of such bonds for marketable Treasury notes with a 1.5 percent coupon pursuant to a holder option); Rev. Rul. 87-19, 1987-1 C.B. 249 (noting that "[a]n adjustment to the interest rate on an issue of bonds pursuant to an interest adjustment clause does not result in an exchange under section 1001 of the Code."); Rev. Rul. 72-265, 1972-1 C.B. 222 (stating that "[t]he conclusion that no gain or loss is realized upon the conversion of a corporate debenture into stock of the obligor corporation . . . remains applicable except where provisions of the Code specifically require that gain be recognized").

With respect to the exception for changes occurring pursuant to an instrument's terms, it is also worth considering the Service's holding in Revenue Ruling 90-109,[13] where it held that a change to the insured under a life insurance policy resulted in a deemed exchange of the policy under section 1001, even though such change occurred pursuant to an option contained in the original policy. The ruling stated:

> A change in contractual terms effected through an option provided in the original contract is treated as an exchange under section 1001 if there is a sufficiently fundamental or material change that the substance of the original contract is altered through the exercise of the option. Under such circumstances, the old contract is treated as if it were actually exchanged for a new one.

Revenue Ruling 90-109 suggests that, at least in the context of life insurance policies, a change made pursuant to a contract's original terms may cause a deemed exchange under section 1001 where the change is "fundamental." While it is unclear whether the principle articulated in that ruling applies beyond life insurance policies, subsequent rulings and pronouncements by the Service suggest that it may be more broadly applicable.[14]

b. Application of a Pursuant to the Terms Exception to Derivative Modifications

Consistent with the discussion above, we recommend that changes to a derivative occurring pursuant to its terms generally be excluded from modification treatment. We set forth below how the Regulations could implement such an exception in the context of the following types of changes to the terms of a derivative or the asset(s) referenced by a derivative: (i) changes occurring pursuant to a formula or algorithm, (ii) changes resulting from the rebalancing of indices that either are widely used and publicly quoted or track a broad market or market segment, (iii) changes resulting from the exercise of a unilateral option, (iv) changes to respond to extraordinary events (including corporate actions), (v) changes to correct errors, and (vi) changes made pursuant to the exercise of routine judgment.

(i) Formulaic or Algorithmic Changes

As an initial matter, we believe that a derivative generally should not be considered to experience a modification where it references an index or basket and the

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13 1990-2 C.B. 191.

14 *See, e.g.*, I.L.M. 200515019 (Dec. 3, 2004); Tech. Adv. Mem. 201142020 (July 12, 2011); I.L.M. 201547004 (Aug. 11, 2015).

components of such index or basket change in a manner determined entirely pursuant to a formula or algorithm. Such an exclusion from modification treatment would be consistent with the Basket Notices, which provided that the taxpayer or its "designee" would not be treated as exercising discretion to change the assets in a reference basket or trading algorithm "if changes in the assets in the reference basket or the trading algorithm are made according to objective instructions, operations, or calculations that are disclosed at the inception of the transaction (the rules) and T does not have the right to alter or amend the rules during the term of the transaction or to deviate from the assets in the reference basket or the trading algorithm selected in accordance with the rules."[15] This approach also would be consistent with the notional principal contract ("NPC") regulations in Treas. Reg. § 1.446-3, which permit the payments made under a single NPC to be based on any "objective financial information" (*i.e.*, current, objectively determinable financial or economic information that is not within the control of any of the parties to the contract and is not unique to one of the parties' circumstances). Under such regulations, a single NPC could reference, for example, the return on the 10 stocks in the Dow Jones Industrial Average that had the highest dividend yield in the prior quarter (*i.e.*, such return would be objective financial information). There is no suggestion that variances in which stocks have their performance included in that information would cause an exchange of the existing NPC for a new NPC for purposes of section 1001; implicitly, the regulations allow such variances to occur within one NPC as long as the definition of objective financial information is met.

We believe that the same principle should be incorporated into the Regulations to ensure that a derivative will not be treated as modified when the assets in the underlying index or algorithm change pursuant to the original agreement between the parties, provided that the taxpayer does not have the right pursuant to the applicable agreement to alter the rules during the term of the transaction or to change the assets in the reference basket or the trading algorithm selected in accordance with the rules. For this purpose, the Regulations should make clear that where a basket or index references, in whole or in part, the recommendations or determinations of a financial institution's research analysts, the resulting changes should be treated as occurring pursuant to a formula or algorithm as long as such analysts have no connection to the creation or maintenance of the basket or index.

We believe that non-modification treatment should apply regardless of the extent of the changes resulting from the application of the formula or algorithm. In this regard, we note that the Service has indicated that changes that occur automatically might nevertheless result in a deemed exchange of an instrument where the changes are fundamental.[16] For this proposition, the Service has pointed to its holding in Revenue Ruling 90-109. We believe that the holding in that ruling should be limited to the life insurance

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15 Notice 2015-73, Section 2.03; Notice 2015-74, Section 2.03.

16 *See, e.g.*, I.L.M. 200515019 (Dec. 3, 2004); Tech. Adv. Mem. 201142020 (July 12, 2011); I.L.M. 201547004 (Aug. 11, 2015).

context, and that the Regulations should provide that no modification results from formulaic or algorithmic changes, regardless of how extensive such changes are.[17]

(ii) Changes Resulting from the Rebalancing of Certain Indices

The Regulations also should exclude from modification treatment changes in any index referenced by a derivative if such index either (i) is widely used and publicly quoted ("Widely Used Indices") or (ii) tracks a broad market or market segment ("Tracking Indices"), in each case regardless of whether human input is required in order to determine the components and weightings that comprise the index. This exclusion would be consistent with both (i) the exception generally provided in the tax law for changes pursuant to an instrument's original terms, and (ii) the Basket Notices, which do not require reporting of an option or contract where such option or contract references a Widely Used Index or Tracking Index.[18] It would be helpful, however, for the government to provide guidance regarding when an index is considered a Widely Used Index. In this regard, we recommend that an index be considered a Widely Used Index if either (i) the index is licensed for use by three or more financial institutions, (ii) shares of an exchange traded fund that tracks such index are regularly traded, (iii) a publicly offered registered investment company (as defined in section 67(c)(2)) tracks such index, or (iv) the index is traded through futures contracts or option contracts.

Notwithstanding the foregoing, we believe that no exclusion from modification treatment should be available where the taxpayer or its designee provides material input into such changes after the inception of the transaction.

(iii) Exercise of a Unilateral Option

Where one party to a derivative has a unilateral option to change one or more terms of the derivative (*e.g.*, the duration of the derivative or the financing rate on a total return swap), such a change should not be considered a modification (subject to the discussion in the next paragraph).[19] Such an exclusion is consistent with the treatment of unilateral options under the Debt Modification Regulations and under prior law.

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17 As noted in Part B.2.b.iv below, however, we recommend that the Regulations provide that a change that causes a derivative to be treated as debt should trigger a significant modification, even if the change occurs pursuant to the instrument's terms.

18 Specifically, for purposes of the Basket Notices, a taxpayer is not considered to compensate or select a person to suggest, request or determine changes in the referenced basket or trading algorithm (*i.e.*, make the person the taxpayer's "designee" for purposes of the Basket Notices) as a result of (i) the person's use or licensing of an index that is widely used, publicly quoted and based on objective financial information or an index that tracks a broad market or market segment or (ii) the person's authority to suggest, request or determine changes in such an index. Notice 2015-73, Section 2.02; Notice 2015-74, Section 2.02.

19 For this purpose, an option is unilateral only if (i) at the time the option is exercised, the other party has no right to alter or terminate the instrument or put the instrument to a person who is related to the issuer, (ii) the exercise of the option does not require the consent or approval of the other party or certain other persons, and (iii) the exercise of the option does not require consideration (other than certain permissible types of consideration). Presumably, options other than unilateral options are not excluded from modification treatment because, in effect, the non-

Notwithstanding the fact that changes to the terms of a derivative (such as the derivative's rate or term) pursuant to a unilateral option generally should not result in a modification of a derivative, we believe that modification treatment may be appropriate where the taxpayer or its designee has the right to, and does in fact, change the asset or assets referenced by the derivative. This should be the case even though the change occurs pursuant to a unilateral option. To provide otherwise would permit a taxpayer or its designee to actively manage a basket referenced by the taxpayer's derivative without triggering a modification as a result of such changes. Of course, even if such change(s) are treated as modifications for purposes of the Regulations, the change(s) should not result in a deemed exchange unless they are considered significant (as discussed below).

(iv) Changes to Respond to Extraordinary Events (Including Corporate Actions)

There should be no modification of a derivative for purposes of the Regulations solely because one or both parties to the derivative exercise routine judgment to respond to extraordinary events (including corporate actions) outside of the taxpayer's control. This would generally be consistent with an exclusion from reporting provided in the Basket Notices for actions taken by the taxpayer or its designee "to respond to an unanticipated event outside of [the taxpayer's] control, such as a stock split, merger, listing or delisting, nationalization, or insolvency of a component of a basket, a disruption in the financial markets for specific assets or in a particular jurisdiction, regulatory compliance requirement, force majeure, or any other unanticipated event of similar magnitude and significance."[20]

We recommend that the Regulations reflect two additional clarifications. First, the corresponding language in the Basket Notices suggests that the relevant change must be "unanticipated" in order for it to be ignored. Whether a change is unanticipated should be irrelevant in determining whether it rises to the level of being considered a modification. For example, if a taxpayer enters into a total return swap with respect to the stock of the target of a corporate merger after the merger has been announced but before it has closed, an adjustment of the swap to reference the stock of the acquirer after the merger should not be considered a modification, even though the parties anticipate that such a change will occur when the swap is executed.

Second, whether the underlying event giving rise to the derivative change would have been a taxable event to the holder of the referenced security should be irrelevant to the treatment of the change. For example, if a total return swap references the stock of a corporation that during the term of the swap is acquired in a stock-for-stock transaction (such that the swap thereafter references the stock of the acquiring corporation), the fact that a holder of the target's stock would have been taxable on the transaction should not be viewed as more meaningful (and thus treated as a modification) from the perspective of the long

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exercising party can either prevent the exercise (directly or by terminating or altering the instrument) or is compensated for such exercise. For the same reason, we believe it would be appropriate for the Regulations to treat a change that occurs pursuant to a non-unilateral option as a modification (unless another exclusion from modification treatment applies).

20 Notice 2015-73, Section 2.03; Notice 2015-74, Section 2.03.

party to the swap than had the underlying transaction been tax-free to a holder of physical shares. Whether the underlying transaction is taxable or tax-free to a holder of physical shares, the long party's exposure to target stock will be adjusted to reference acquirer stock as a result of a transaction not within the long party's control. The fact that the rules of subchapter C would find the transaction to be taxable to an actual stockholder should not change the tax treatment of the long party to the swap.

(v) Changes to Correct Errors

We recommend that the Regulations provide that a change to correct an error made by the parties in the documentation of a derivative does not constitute a modification of the derivative. This would be consistent with the Basket Notices, which provide that a taxpayer or its designee is not considered to have exercised discretion to change a basket[21] or trading algorithm used with respect to a basket option or other derivative solely because the taxpayer or designee has the authority to correct errors in the implementation of the basket option or derivative's rules or calculations made pursuant to the rules. It is quite common for errors in the implementation or calculation of derivatives to occur. It is likely that correction of such errors would be ignored for tax purposes generally, since the correction simply causes the transaction to conform legally to what had been agreed to by the parties. Nevertheless, we recommend that the Regulations make this clear in order to avoid any uncertainty in this area.

(vi) Changes Pursuant to the Exercise of Routine Judgment

We believe that the Regulations also should provide that a derivative change made pursuant to the exercise of routine judgment does not constitute a modification of the derivative by virtue of occurring pursuant to the instrument's terms. For example, assume that a total return swap provides for a financing rate that is a fixed spread over LIBOR, but allows the dealer party to adjust the financing rate to reflect an increase in the cost of hedging its position under the swap. Even though the swap does not provide a precise way to determine the amount of an adjustment to the financing rate, it would be appropriate to exclude such an adjustment from modification treatment where such adjustment occurs solely as a result of the exercise of routine judgment because such an exercise of judgment was specifically contemplated by the original terms of the instrument.[22]

Similarly, changes to an index should be treated as made pursuant to the terms of the index even where certain changes to index components depend on the exercise of routine judgment by the index sponsor or another party pursuant to a pre-determined

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21 For this purpose (and the remainder of this letter), the term "baskets" will refer to both (i) indices that are neither Widely Used Indices nor Tracking Indices and (ii) baskets of reference assets that are not structured as indices (*e.g.*, custom baskets).

22 Such an exception also would be consistent with the Basket Notices, which provide that the fact that a taxpayer has the authority to exercise routine judgment in the administration of an algorithm or an objective instruction, operation or calculation does not prevent the transaction from being excluded from transaction of interest treatment, so long as such routine judgment does not include deviations or alterations to the rules that are designed to improve the financial performance of the reference basket. Notice 2015-73, Section 2.03; Notice 2015-74, Section 2.03.

standard (other than a standard that is principally focused on the financial performance of the index constituents). By way of illustration, the components of an index may be determined through a multi-step process where one of the steps excludes the stock of any issuer that fails to adhere to international norms and principles regarding environmental, social and governance impacts, is involved with controversial weapons, or is in breach of the UN Global Compact Principles. Even though such determinations may involve some amount of subjectivity on the part of the index sponsor or other party exercising the judgment, we believe that the Regulations should deem such changes to be made pursuant to the terms of any derivative referencing the index.

(vii) Change in the Nature of the Derivative

Under the Debt Modification Regulations, subject to certain exceptions, an alteration of a debt instrument that results in an instrument or property right that is not debt for tax purposes is a modification of the instrument that generally is treated as a significant modification, even where such alteration occurs pursuant to the instrument's terms.[23] This rule is presumably based on the notion that a change causing a debt instrument to no longer be treated as debt for tax purposes is so meaningful that it should be treated as *per se* economically significant, regardless of whether such change would otherwise cause a significant modification.

We have considered whether an alteration to the terms of a derivative that causes the derivative to be treated as a debt instrument should be considered a modification even when such change occurs automatically or pursuant to the exercise of a unilateral option. For the reasons described below, we believe that alterations which happen pursuant to the terms of a derivative should not be treated as modifications, even where the derivative might be treated as a debt instrument for tax purposes had it been a newly-issued instrument on the date of the alterations.

It would be highly unusual for a debt instrument to contemplate automatic or optional changes that would cause the instrument to no longer be treated as a debt instrument for tax purposes if it were newly issued. Thus, it is not surprising that the Debt Modification Regulations require re-testing of the instrument when such a change occurs (even if the change occurs pursuant to the instrument's terms).

In contrast, many structured notes have terms that, depending on the changes to the reference asset or index during their term, may cause the structured note to be substantially certain to pay a fixed amount prior to their maturity. For example, a structured note issued for $1,000 may provide for a return linked to the performance of reference assets, such as three times the appreciation in such assets but not to exceed $150 (for a maximum

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23 Treas. Reg. §§ 1.1001-3(c)(2)(ii) and (e)(5)(i). We note, however, that in making a determination as to whether an instrument resulting from a modification of a debt instrument will be recharacterized as an instrument that is not debt, any deterioration in the financial condition of the obligor between the original issue date and the date of the modification is not taken into account. Treas. Reg. § 1.1001-3(f)(7)(ii)(B).

repayment amount of $1,150). In such a case, if the reference assets experience a dramatic increase in value, it may become certain or substantially certain that the holder will receive $1,150, such that one might assert that, had the structured note been newly-issued, it would be characterized as a debt instrument. While it is unclear whether such changes to the payout on the structured note would rise to the level of being considered alterations potentially treated as modifications, taxpayers may have concerns that modification treatment could apply. We believe that such an instrument should not be treated as modified for purposes of the Proposed Regulations. First, we believe that an instrument should not be treated as altered (and thus should not be modified) where the instrument's payout continues to be determined pursuant to a single formula, such as the one described above. Moreover, it would be unadministrable for the issuer and holders of a structured note to continuously re-test whether the instrument would be treated as debt for tax purposes if newly-issued. Such re-testing would be particularly challenging given the uncertainty surrounding when such an instrument would be treated as debt for tax purposes.

We recognize that more meaningful concerns may exist where a derivative, either directly or through an index, references a formula that will or may change during the term of the derivative in a manner that is expected to result in a debt-like return over the derivative's remaining term. While it is more likely in such a case (relative to the example in the preceding paragraph) that the derivative would be treated as experiencing an alteration, it would be unworkable to comply with a rule that would require re-testing of a derivative every time a referenced formula changes pursuant to its terms to determine whether the derivative at the time of the change is sufficiently debt-like to be treated as debt if it were a newly-issued instrument.[24] Further, as noted in the prior paragraph, substantial uncertainty exists regarding the circumstances in which a particular instrument would be properly characterized as debt for tax purposes. Accordingly, given the practical and administrability concerns noted above, we believe that actual or deemed alterations to a derivative instrument's terms that occur automatically or pursuant to the exercise of a unilateral option should not be treated as a modification of the derivative, even where such instrument could potentially be characterized as a debt instrument if the instrument were newly-issued.

(viii) Upsizing or Downsizing of a Derivative[25]

The parties to a derivative will often "upsize" a derivative by increasing the notional amount of the derivative when there is a desire to increase the economic exposure provided by the derivative. While the parties could simply have entered into a separate

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24 For instruments held in book-entry form through a depositary (*e.g.*, the Depositary Trust Company), the requirement for re-testing a derivative every time a referenced formula changes would create enormous practical challenges in ensuring timely notification of such a potential reclassification of the instrument to the depositary and ensuring accurate information reporting to the Service and to holders.

25 This section addresses increases or decreases to the notional amount of a derivative that occur other than pursuant to an instrument's terms. Where the terms of a derivative provide for automatic increases or decreases to the instrument's notional amount (*e.g.*, in order to keep the volatility of the instrument approximately constant), for the reasons described in Part B.2.b above the instrument should continue to be treated as the same instrument as the instrument prior to the increase or decrease to the notional amount, and thus there should be no new instrument and no termination of all or part of the existing instrument.

derivative to reflect such increased exposure, it may be more convenient for the parties to simply change the notional amount reflected in the existing derivative. In such a circumstance, it should be clear that the true substance of the transaction is that the existing derivative has continued and the parties have simply entered into a new derivative with a notional amount equal to the excess of the upsized notional amount over the original notional amount. We recommend that the Regulations confirm that this is the case by providing that an increase in the notional amount of a derivative, without other changes being made to the terms of the derivative, is not a modification of the original derivative, and instead is treated as the execution of a new derivative with a notional amount equal to such increase.[26]

Similarly, the parties to a derivative will often "downsize" the derivative by decreasing its notional amount in order to reduce the economic exposure provided by the derivative. It should be clear that such a downsizing is treated as a partial termination of a pro rata portion of the existing derivative because such treatment represents the economic reality of the change. In other words, the existing derivative, to the extent of its downsized notional amount, is not changed by virtue of the downsizing. Moreover, the downsizing of a derivative is analogous to a pro rata prepayment on a debt instrument, which generally is treated as a retirement of the relevant portion of the instrument, and is not treated as a modification to the remaining debt instrument, because it does not result in a change to the instrument's terms.[27] As a result, we recommend that the Regulations confirm the treatment of the downsizing of a derivative as a partial termination of a pro rata portion of the existing derivative, and not as a modification of the remainder of the derivative.

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26 We recognize that in the case of non-delta one derivatives (*e.g.*, call options), a change to the notional amount of the derivative is likely to be accompanied by a change to economic terms, such as the strike price or premium of the derivative. In such a case, it would be reasonable to treat such other changes as a modification of the original derivative, and thus as a deemed exchange of the original derivative for a new derivative, if such modification is found to be significant under the standards discussed below.

27 *See, e.g.*, Treas. Reg. § 1.1275-(f)(1) ("A pro rata prepayment is treated as a payment in retirement of a portion of a debt instrument, which may result in a gain or loss to the holder. Generally, the gain or loss is calculated by assuming that the original debt instrument consists of two instruments, one that is retired and one that remains outstanding.").

(ix) Other Changes Involving the Exercise of Discretion

Lastly, the Regulations should address the circumstances in which a derivative that references a basket will experience a modification under the Regulations if one or more of the reference assets comprising the basket are changed pursuant to the exercise of discretion and none of the exceptions described above applies. While it seems reasonable for the Regulations to provide that a derivative modification will occur where the taxpayer itself exercises discretion to change the basket components, where such discretion is exercised by a person other than the taxpayer (and in particular a person who has no direct relationship with the taxpayer) the appropriate tax treatment is less clear. We recommend that the Regulations clearly identify when such an exercise of discretion to modify a basket will constitute a modification of a derivative referencing such basket and, if modification treatment depends on whether the party exercising discretion is the taxpayer's "designee" (similar to the approach taken in the Basket Notices), provide detail on when such a person will be treated as a designee.

3. Determining What Modifications Are Significant

a. Assignments of Derivatives

Current regulations provide a rule under which an assignment of a derivative satisfying certain requirements does not constitute a significant modification (and thus does not affect the nonassigning party). Specifically, under Treas. Reg. § 1.1001-4(a), the assignment of a derivative contract is not a realization event to the nonassigning party if (i) each party to the assignment is either a dealer or a clearinghouse, (ii) the terms of the derivative contract permit the assignment, whether or not the consent of the nonassigning counterparty is required for the assignment to be effective, and (iii) the terms of the derivative contract are not otherwise modified in a manner that results in a taxable exchange under section 1001. We recommend that this rule be preserved in the Regulations, but that the second requirement under Treas. Reg. § 1.1001-4(a) (*i.e.*, that the terms of the derivative contract permit the assignment, whether or not consent is required) be deleted. In particular, it is not apparent why a derivative that is silent regarding assignment would not benefit from non-realization under the rule, while a derivative that permits the assignment, but only with consent of the nonassigning party, would benefit from the rule. In either case, the ability to assign the contract requires the agreement of the nonassigning party. We believe that the ability to benefit from non-realization treatment should not turn on whether the contract specifically mentions the possibility of assignment.

b. Changes to Security or Credit Enhancement

Under the Debt Modification Regulations, a modification that releases, substitutes, adds or otherwise alters the collateral or credit enhancement for a recourse debt instrument is not a significant modification unless the modification results in a "change in payment expectations."[28] This rule is based on the principle that because the security or

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[28] Treas. Reg. § 1.1001-3(e)(4)(iv)(A). For this purpose, a modification results in a "change in payment expectations" if as a result of a transaction, there is either a substantial enhancement (or substantial impairment) of the obligor's capacity to meet its payment obligations and that capacity went from being primarily speculative to adequate or from adequate to primarily speculative.

credit enhancement for a debt instrument is provided in order to ensure payment, a change to such features should not result in a deemed exchange unless it actually changes meaningfully the likelihood that the creditor will be paid. The same principle should apply to derivative modifications. This type of exception would be particularly important in the context of derivative modifications because alterations to collateral arrangements occur with some frequency. As a result, we recommend that the Regulations provide that changes to the security or credit enhancement for a derivative do not constitute a significant modification unless such changes result in a change in payment expectations.

c. Changes That May Result in a Significant Modification

(i) Change to the Referenced Asset(s)

Where the asset or assets referenced by a derivative change in a manner that is not excluded from modification treatment (as discussed above), such changes generally should (subject to the exceptions discussed below) result in a significant modification. For example, if a taxpayer enters into a total return swap with a dealer referencing Corp A stock, and during the term of the swap the parties negotiate a change to the swap to reference Corp B stock, the modification to the swap generally should be viewed as significant. However, a derivative that references a U.S. listing of a stock should not be treated as significantly modified if the referenced asset is changed to a European listing of the same stock (where the change in listing is not expected to have a material effect on the economic performance of the derivative).

In certain circumstances, it would be appropriate not to treat a change to the referenced asset(s) as being significant. First, where the asset referenced by the modified derivative is expected to perform economically in a manner that is substantially identical to the asset referenced by the original derivative, such change should not be considered significant. This could occur, for example, where the derivative references one class of common stock of an issuer and is modified to reference a different class of common stock of the same issuer. To treat such a change as a significant modification would potentially permit taxpayers to cause significant modifications in order to accelerate built-in gains or losses without meaningfully changing the economic profile of the derivative.

Second, we recommend that the Regulations provide an exception from significant modification treatment in the case of a derivative referencing a basket (including an index that is not otherwise excluded from modification treatment) where the changes to the basket component within a particular period of time are insignificant. For example, the rule could provide that changes to components reflecting less than 10 percent of the notional amount of the basket within a 12-month period would not be considered significant. Not providing such a safe harbor would permit a taxpayer to trigger a built-in gain or loss in a derivative intentionally by making a minor change to a basket referenced by the derivative.

(ii) Change in Timing of Payments

The Debt Modification Regulations provide generally that a modification that changes the timing of payments due under a debt instrument (either through an extension of

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Treas. Reg. § 1.1001-3(e)(4)(vi).

maturity date or through a deferral of payments due prior to maturity) is a significant modification if it results in the "material deferral" of scheduled payments.[29] While the materiality of the deferral depends on all the facts and circumstances, the Debt Modification Regulations provide that a deferral of payments within a safe-harbor period (which runs from the original due date of the first scheduled payment that is deferred for a period equal to the lesser of 5 years or 50 percent of the original term of the instrument) is not a material deferral if the deferred payments are unconditionally payable no later than at the end of the safe-harbor period.[30]

The use of a material deferral standard in the context of debt modifications appears sensible because the dates on which payments are required to be made (and in particular the maturity date) are among the most important characteristics of a debt instrument because such payment dates establish the date on which the creditor is entitled to demand payment. By extending the term of a debt instrument, the creditor is allowing the debtor to have use of the funds for a longer period of time.

While the use of a material deferral standard may be appropriate in the context of certain types of derivatives, it is not clear that such a standard should apply to all derivatives. For example, a material change to the date on which an option can be exercised may have economic significance because one of the key factors in determining the economic value of an option is its remaining term.

In contrast, it is less clear that an extension to the term of a total return swap meaningfully changes the economic arrangement between the parties in a manner that should trigger a deemed exchange. The economic arrangement reflected in a typical total return swap is that the long party has the economic upside and downside in the underlying asset (offset by a finance charge) for so long as the swap is outstanding. Extending the term of a swap at its then-inherent value would appear not to change the day-to-day economic arrangement that exists between the parties, at least where each party has the right to terminate the swap at any time.[31] It is also noteworthy that the extension of the term of a total return swap typically does not require a concomitant change to the swap's economic terms. Consequently, we recommend that the Regulations provide that the extension of the term of a total return swap should not be considered a significant modification. If, however, the Regulations provide that an extension to the term of a swap or any other type of delta-one derivative[32] may be treated as a significant modification, we recommend that the Regulations provide a safe harbor similar to that contained in the Debt Modification Regulations (*i.e.*, an

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29 Treas. Reg. § 1.1001-3(e)(3)(i).

30 Treas. Reg. § 1.1001-3(e)(3)(ii).

31 The view that such an extension does not change the economic arrangement is less clear where one or both parties lack the ability to terminate the swap at any time.

32 We recognize that the economic profiles of non-delta one derivatives may be too varied to lend themselves to a safe harbor based on the length of the extension. As an alternative, the government could consider a safe harbor based on the amount of the consideration paid in exchange for the extension relative to the fair market value of the derivative on the date of the extension.

extension is not considered significant if it is for a period no greater than the lesser of 5 years or 50% of the derivative's original term).

(iii) A Change to the Financing Rate of a Derivative

Where a derivative (such as a total return swap) requires one party to make periodic payments based on a financing rate (typically calculated as a benchmark rate (*e.g.*, LIBOR or SOFR) plus a spread), the parties will sometimes agree to modify the financing rate to change the benchmark rate and/or the spread.[33] A change to the spread from the benchmark rate should not constitute a significant modification unless the change exceeds a safe harbor amount. We think it would be reasonable for the Regulations to incorporate a safe harbor of 0.25% per annum for this purpose, which would be generally consistent with the yield safe harbor contained in Treas. Reg. § 1.1001-3(e)(2)(ii)(A). In October 2019, the government released proposed regulations addressing modifications of derivatives and other contracts to implement a change from an interbank offered rate ("IBOR") to an alternative rate.[34] Those proposed regulations generally provide that the alteration from an IBOR-based rate to an alternative rate is not a modification for purposes of section 1001 so long as (i) the rate on the modified contract is a "qualified rate" (including any "qualified floating rate" within the meaning of Treas. Reg. § 1.1275-5(b)), (ii) the fair market value of the contract after the alteration, including any one-time payments, is substantially equivalent to the fair market value before the alteration and (iii) the IBOR-based rate before the alteration and the benchmark rate after the alteration are based on transactions in the same currency or are reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds in the same currency. We acknowledge that the government issued the proposed regulations in order to facilitate an orderly transition from IBOR rates and to minimize potential market disruption. In light of their limited intended purpose, we appreciate that such regulations should not be viewed as a general precedent for other financing rate changes. Nevertheless, we believe that the proposed IBOR transition regulations provide a good starting point for addressing financing rate changes outside the IBOR transition context and, for that reason, suggest that the government consider providing a similar exception from modification treatment in the case of any financing rate change that satisfies all of the requirements of the proposed IBOR transition regulations.

d. Change in Frequency/Timing of Determining Rate Resets

Where a derivative requires one party to make periodic payments based on a financing rate that is calculated as a spread over a benchmark rate (*e.g.*, LIBOR or SOFR), the parties will sometimes modify the instrument to change the frequency at which the financing rate is reset (*e.g.*, from quarterly resets to monthly resets). We recommend that such alterations to the frequency of rate resets not be treated as significant modifications under the Regulations. If rate resets could trigger significant modifications, a taxpayer could potentially trigger the recognition of a built-in gain or loss in a derivative intentionally simply

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33 Changes to the financing rate of a derivative that occur automatically or pursuant to the exercise of a unilateral option are addressed in Part B.2.b above.

34 Prop. Reg. § 1.1001-6.

by increasing or decreasing the frequency of rate resets, without meaningfully affecting the expected economic profile of the derivative.

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I would be happy to discuss this matter further with you or to provide any assistance that you may require.

Yours truly,

Maureen Smith

cc: Krishna Vallabhaneni, Tax Legislative Counsel
Brett York, Deputy Tax Legislative Counsel
Jeffrey Van Hove, Senior Advisor (Office of Tax Policy), U.S. Treasury
William Paul, Deputy Chief Counsel (Technical), Internal Revenue Service
Helen Hubbard, Associate Chief Counsel (Fin. Inst. & Products), IRS Chief Counsel
Larry Salva, Deputy Associate Chief Counsel (Fin. Inst. & Products), IRS Chief Counsel
Diana Imholtz, Special Counsel to the Associate Chief Counsel (Fin. Inst. & Products), IRS Chief Counsel
Ned Blanchard, Senior Level Counsel (Fin. Inst. & Products), IRS Chief Counsel