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By Electronic Delivery

May 4, 2018

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RE: Application of Amended Section 451(b) to Market Discount and OID

Dear Mr. West and Mr. Paul:

The Investment Company Institute[1] and its members are concerned about the scope of the amendments to section 451(b) in the recently enacted tax legislation commonly referred to as the Tax Cuts and Jobs Act of 2017 (the Act).[2] Although we believe the correct reading of the statutory language, consistent with Congressional intent, is quite limited, we welcome confirmation that section 451(b) will not be interpreted as effectively overriding the long-standing statutory and regulatory provisions on the accrual of market discount and original issue discount (OID). In some cases, the resulting timing differences may be significant; in others, the differences may be minor, and any potential benefit to the government would be far outweighed by the compliance burden that regulated investment companies (RICs) would bear.

We thus urge the Treasury Department and the Internal Revenue Service (IRS) to clarify the application of the amendments to section 451(b). Specifically, we ask the government to issue guidance confirming that amended section 451(b): (1) does not apply to market discount; and (2) applies to OID only with respect to items, such as certain fees, that are treated as something other than discount under Generally Accepted Accounting Principles (GAAP).

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[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$21.7 trillion in the United States, serving more than 100 million US shareholders, and US$7.5 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] Pub. L. No. 115-97, §13221, 131 Stat. 2054 (2017).

I. Background

New section 451(b)(1) states in general terms that the "all events test" is met with respect to an item of gross income for an accrual method taxpayer no later than when the taxpayer takes such item into account as revenue for financial accounting purposes on an "applicable financial statement."[3] New section 451(b)(2) then states that the general rule in (b)(1) does not apply to the extent the Internal Revenue Code specifies a special rule of accounting, other than a rule in Part V of Subchapter P (sections 1271 to 1288).

The section 451(b) amendments in the Act are similar to those in the Committee on Ways and Mean's Discussion Draft of the Tax Reform Act of 2014 that then Chairman Dave Camp developed (the Camp Bill).[4] The Camp Bill's amendments to section 451 arose in two different sections.

Section 3303 of the Camp Bill would have amended section 451 to require an accrual-method taxpayer to include an item of income no later than the tax year in which that item is included in income for financial statement purposes. The Committee on Ways and Means' explanation of the Camp Bill[5] noted that the Internal Revenue Code contained numerous exceptions to the general requirement that a taxpayer include any item of income in the taxpayer's gross income in the year in which the income is received. The Camp Bill sought to limit a taxpayer's ability to defer the recognition of income, while also explicitly repealing several of these exceptions. Notably, the Camp Bill did not specifically reference the all events test.

Section 3413 of the Camp Bill then would have amended the amendment in section 3303 by inserting at the beginning of the provision, "Notwithstanding any other provision of law (including part V of Chapter P) …" The Committee's explanation noted that certain fees earned by credit card issuers and other financial institutions were treated as OID for tax purposes, thus deferring the imposition of tax on such income.[6] The amendment in section 3413 thus would have prohibited a taxpayer from treating as OID fees and other amounts it received if the amounts were subject to section 3303 of the Camp Bill.

Section 3413 of the Camp Bill targeted case law and IRS guidance that permitted credit card companies to treat certain fees as OID. In *Capital One Financial Corporation v. Comm'r,*[7] the Tax Court held that the recipient of those fees could treat them as offsets to amounts loaned, thereby creating OID that the recipient included in income based on payments on the credit card

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[3] "Applicable financial statement" is defined in section 451(b)(3).

[4] Ways and Means Committee Print, Tax Reform Act of 2014, 113th Cong. 2d Sess., as released on February 26, 2014 (WMCP 113-6, Sept. 2014), *available at* http://www.gpo.gov/fdsys/pkg/CPRT-113WPRT89455/pdf/CPRT-113WPRT89455.pdf.

[5] *Id.*, Section-by-Section Summary, p. 88.

[6] *Id.*, p. 100.

[7] 133 T.C. 136 (2009).

accounts.[8] The IRS previously had approved similar treatment for credit card cash-advance fees and late fees.[9] The Camp Bill, had it been enacted, would have limited the ability of taxpayers to defer the inclusion of such fees into income.

The language amending section 451(b) in the Act is substantially similar to that in the Camp Bill. Likewise, Congress intended for the amendments to section 451(b) in the Act to overrule the tax treatment of those credit card and other fees. In describing the changes to current law, the Conference Report to the Act specifically notes that late-payment fees, cash-advance fees, or interchange fees (the subject of the *Capital One* case and IRS guidance), which are included in revenue for financial statement purposes when received, are subject to the new law.[10]

It is unclear, however, to what extent section 451(b) applies to items beyond these types of credit card and other fees. Specifically, ICI and its members are concerned that section 451(b) could be interpreted to apply to market discount and the rate of accrual of OID on debt. Unlike credit card and other fees, market discount and "traditional" OID are treated as discount for both book and tax purposes. The timing of realization and accrual, however, may differ. If section 451(b) applies to market discount and traditional OID, the tax and compliance burdens to RICs may be significant.

II. The Statute's Construction Demonstrates that Section 451(b) Does Not Apply to Market Discount

A. The Statute Does Not Require That Book Accounting for Debt Instruments Override Completely the Statutory Scheme of Sections 1271-1288.

Section 451 did not apply to market discount prior to the enactment of the Act, and the amendments to section 451(b) do not change that fact. The general rule of section 451(b)(1) provides that the "all events test" is met no later than when the taxpayer takes an item into account as revenue for financial accounting purposes. Section 451(b)(2) then provides an exception to this general rule, stating that section 451(b)(1) does not apply to an item of gross income that is subject to a special method of accounting under Chapter 1 of the Internal Revenue Code (the primary exception). Section 451(b)(2), however, also carves out an exception from this primary exception to section 451(b) for the special rules in Part V of Subchapter P (the secondary exception). This carve-out was necessary to allow section 451(b)(1) to override the tax treatment of credit card and other fees as giving rise to OID rather than immediate fee income, which was the primary purpose of the amendments to section 451(b). Without the secondary exception to the primary exception to the general rule, these fees would not have been subject to the general rule, because they are items that are subject to a special method of accounting.

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[8] *See* Treas. Reg. §1.1273-2(g)(2).

[9] Rev. Proc. 2004-33, 2004-1 C.B. 989; Rev. Proc. 2005-47, 2005-2 C.B. 269.

[10] H.R. REP. No. 115-466, at 427 (2017) (Conf. Rep.) (hereinafter, the "Conference Report").

The secondary exception thus does not *mandate* that book accounting override *all* the statutory rules in sections 1271 through 1278; it simply provides an override in specific cases. In other words, in construing the interaction between section 451(b)(1) and the OID and market discount rules, the analysis should be just the same as if the exceptions in section 451(b)(2) did not exist at all.[11]

Indeed, the legislative history to section 451(b) strongly implies that Congress envisioned a very limited interaction between financial statement accounting and the OID and market discount rules. Specifically, the Conference Report states, "[section 451(b)] directs accrual method taxpayers with an applicable financial statement to apply the income recognition rules under section 451 *before* applying the special rules under part V of subchapter P …" (emphasis added).[12] The use of the word "before" indicates an intent to limit the interaction between financial accounting and the rules of Part V of Subchapter P to the determination of whether an item is income when received (such as a credit card fee) or gives rise to discount, not to specify how discount accrues.[13]

B. Market Discount Is Included in Income When Realized unless the Taxpayer Elects to Accrue It Currently.[14]

1. <u>The Pre-Act Realization Event Treatment of Market Discount</u>

The Tax Reform Act of 1984 codified the tax treatment of market discount in sections 1276-1278.[15] Before the enactment of the statutory market discount rules, several courts had held that market discount was includible in income only upon receipt of a principal payment, meaning upon realization.[16] In one case the court did hold that an accrual-method taxpayer engaged in the business of buying and selling loans at a discount had to include the discount on purchased loans in income over the life of the loan; however, that case has not been followed and

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[11] Note that section 3413 of the Camp Bill specifically applied to discount *only if* the amounts received were otherwise subject to section 3303. *See* Ways and Means Committee Print, Tax Reform Act of 2014, Section-by-Section Summary, p. 100.

[12] Conference Report, at 428.

[13] *See* Id. ("Thus, for example, to the extent amounts are included in revenue for financial statement purposes when received (e.g., late-payment fees, cash-advance fees, or interchange fees), such amounts generally are includible in income at such time in accordance with the general recognition principles under section 451.").

[14] Analogous arguments apply to acquisition discount on short-term nongovernment obligations to the extent it exceeds OID. Such discount is not included in income as it accrues unless the taxpayer makes an election under section 1283(c)(2). For ease of presentation, the discussion in the text will be limited to the market discount rules, but should be read to include the corresponding issue for the excess of acquisition discount over OID.

[15] Pub. L. No. 98-369, §41(a), 98 Stat. 494.

[16] *See, e.g., Corn Exchange Bank v. Comm'r*, 6 B.T.A. 158 (1927); *Smith v. Comm'r*, 48 T.C. 872 (1967), *aff'd in part*, 424 F.2d 219 (2d Cir. 1970); *Shafpa Realty Corp. v. Comm'r*, 8 B.T.A. 283 (1927); *Potter v. Comm'r*, 44 T.C. 159, 174-78 (1965), *acq*. 1966-2 C.B. 6; *Darby Investment Corp. v. Comm'r*, 37 T.C. 839 (1962), *aff'd per curiam*, 315 F.2d 441 (6th Cir. 1963).

appears contrary to an earlier decision of the same court.[17] This common-law treatment of market discount also implicitly is confirmed by the legislative history to the 1984 market discount rules, which makes no mention of any change to the timing of market discount, or of any difference between accrual and cash-method holders.[18]

Section 1276(a)(1) provides that any gain on the disposition of a market discount bond (which under section 1271(a)(1) includes a redemption) is treated as ordinary income to the extent of the accrued market discount on the bond. Section 1276(a)(3) provides a comparable rule for the receipt of a partial principal payment on a market discount bond. Consequently, section 1276(a) requires recognition of market discount only when there is a realization event with respect to the debt instrument. Section 1276(b) provides rules for calculating the amount of market discount that must be taken into account at disposition or upon pay-down of the principal. It states that market discount accrues daily and ratably over the life of the bond unless the taxpayer elects to compute the accruals using a constant interest rate (i.e., yield principles analogous to those under the OID rules). Despite the references to "accrued" market discount, section 1276 does not require an accrual method of accounting, even by taxpayers that otherwise use an accrual method.

Section 1278(b) gives taxpayers an election to include market discount in income as it accrues. Section 1278(b)(1) provides that the general rule of realization accounting for market discount in section 1276 shall not apply if the taxpayer elects to include market discount currently. The amounts of those accruals are then determined under the calculation rules in section 1276(b). The ability to elect current inclusion, however, does not alter the fact that the market discount rules generally apply realization principles.

Significantly, sections 1276 through 1278 draw no distinction between cash-method and accrual-method taxpayers.[19] Thus, even though section 1276(b) makes clear that market discount accrues over the life of a market discount bond, section 1276 is not an accrual method of accounting, and accrual-method taxpayers are not required to include market discount in income as it accrues unless they so elect under section 1278(b). In this respect, the statutory

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[17] *Vancoh Realty v. Comm'r*, 33 B.T.A. 918 (1936). Notably, nine years earlier, the Board of Tax Appeals held in *Corn Exchange Bank* that an accrual method holder need not accrue discount on purchased bonds, stating: "This discount is not earned or accrued in annual installments and cannot be income to the holder of the bond, either as additional interest or as a separate item of income." 6 B.T.A. 158, 161 (1927). The *Vancoh Realty* decision did not discuss, or even cite, *Corn Exchange Bank*.

[18] *See* S. PRT. No. 98-169, Vol 1., at 155 (1984) ("Capital gain treatment is accorded to the appreciation in value attributable to market discount on an obligation that was issued by a corporation or governmental unit and held for more than one year (sec. 1232). … The committee appreciates that the theoretically correct treatment of market discount, which would require current inclusion in the income of the holder over the life of the obligation, would involve administrative complexity."); Ways and Means Committee Print, Tax Reform Act of 1984, 98th Cong. 2d Sess., at 56 (WMCP 98-25, Mar. 1984); Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 93 (1984).

[19] Contrast sections 1281-1283, which deal with short-term obligations (debt instruments with a term of one year or less). The general rule in section 1281 is that taxpayers must include discount on short-term obligations as it accrues, but this rule generally is not applicable to cash-method taxpayers.

market discount rules did not change the treatment of the holders of market discount bonds, other than adding the current inclusion election.

Under this statutory scheme, the requirement that market discount be included in income only at maturity or on disposition is not based on the all events test. Rather, it is based on specific statutory rules that (consistently with prior common law) treat market discount as an item governed by realization principles rather than by accrual principles, absent an election by the taxpayer to let accrual principles govern. In other words, market discount is not included in income over the life of a market discount bond because Congress specifically chose to make the treatment of market discount as an accrual item elective.

2. The Act Deals Only with the All Events Test.

Section 451(b)(1) by its terms deals only with the all events test. Thus, the Act does not apply to items of income to which the all events test does not apply.[20]

The all events test determines when an item accrues. Normally, this also determines when the item must be taken into income by an accrual method taxpayer.[21] Under common law and the 1984 statutory regime, however, market discount is taken into account using realization principles, rather than under the all events test. The timing of when market discount accrues does not determine the timing of its inclusion in income unless the taxpayer so elects. As noted above, section 1276 sets rules for the "accrual" of market discount solely for purposes of calculating the amount of gain treated as ordinary income at disposition or maturity of the debt instrument.

Footnote 872 in the Conference Report specifically states that section 451(b) "does not revise the rules associated with when an item is realized for Federal income tax purposes and, accordingly, does not require the recognition of income in situations where the Federal income tax realization event has not yet occurred."[22] Therefore, section 451(b) does not override the rules in sections 1276 through 1278 that determine when market discount is realized.

Because the all events test does not apply to market discount in the first place, the mention of part V of Subchapter P in section 451(b)(2) does not otherwise bring market discount within the scope of section 451(b). Nevertheless, confirmation that section 451(b) does not impact market discount would ensure that all taxpayers apply the rules in the same manner.

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[20] The version of section 451(b) contained in section 3303 of the Camp Bill did not reference the all events test but rather provided that an item must be included in gross income for tax purposes no later than when it is treated as income for book purposes. The change from an income inclusion rule to a reference to the all events test provides a further indication that Congress did not intend to require current inclusion in income of accrued market discount absent a section 1278(b) election.

[21] *See* Treas. Reg. §1.451-1(a)(1).

[22] Conference Report at 428.

III. Congress Did Not Intend for Section 451(b) to Override the Statutory Rules for Market Discount and OID That Is Treated as Discount for Book Purposes.

A. The Legislative History of Section 451(b) Indicates That Section 451(b) Was Not Intended to Apply to Market Discount and All OID.

As discussed above, the amendments to section 451(b) were modeled on substantially similar provisions included in the Camp Bill. The explanation of the Camp Bill makes clear that the intent was to overturn *Capital One* and prior IRS guidance that permitted taxpayers to treat certain fees as OID, including the issue price rule in Treas. Reg. § 1.1273-2(g). The Camp Bill also contained a separate provision that would have required the current inclusion in income of market discount as it accrues (subject to limitations designed to cap accruals in the case of distressed debt).[23] Thus, under the Camp Bill, it was clear that the amendments subsequently enacted in section 451(b) did not apply to require the current inclusion in income of market discount.

With a few exceptions, the language in the Act mirrors that in the corresponding provision of the Camp Bill.[24] It is reasonable to conclude that it thus had the same purpose: To override the current treatment of certain fees as OID. There is nothing in the legislative history of the Act, nor any policy reason, to suggest that Congress intended for section 451(b) to be broader than its predecessor in the Camp Bill, such that it overrides all of the statutory and regulatory rules regarding market discount and OID. If the government applied such a broad interpretation of section 451(b), it effectively would cede tax policy in some cases to the Financial Accounting Standards Board (FASB), which determines the standards under GAAP.

Congress's inaction on a specific proposal to amend the market discount rules also suggests that Congress did not intend to change the market discount rules indirectly through section 451(b). Although the Act includes several provisions that are modeled after the Camp Bill, Congress did not include a version of the specific market discount provision from the Camp Bill in the Act that would have required current inclusion of market discount in income as it

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[23] Ways and Means Committee Print, Tax Reform Act of 2014, §3411, *supra* note 4. Congress and previous Administrations have considered amending the tax law to require the current inclusion in income of market discount. For example, in October 1987, the House of Representatives passed a bill that generally would have required the current accrual of market discount. Omnibus Budget Reconciliation Act of 1987, H.R. 3545, 100th Cong., 1st Sess., §10118 (as passed by the House, Oct. 29, 1987). The Senate version of this bill did not contain a comparable provision, and the proposal was dropped in conference. *See* H.R. REP. NO. 100-391, at 1056-57 (1987) and H.R. REP. NO. 100-495, at 932-33 (1987) (Conf. Rep.). In its Fiscal Year 2000 and Fiscal Year 2001 budgets, the Clinton Administration proposed requiring holders that use an accrual method of accounting to include market discount in income on a constant-yield basis as it accrues. FY 2000 Analytical Perspectives 74, 75, *issued with* The President's FY 2000 Budget Proposal, *available at* *http://www.gpo.gov/fdsys/pkg/BUDGET-2000-PER/pdf/BUDGET-2000-PER.pdf*. The Fiscal 2001 Budget Proposal may be found at *http://www.gpo.gov/fdsys/pkg/BUDGET-2001-PER/pdf/BUDGET-2001-PER.pdf.*

[24] As discussed above, the Act codifies the all events test, thus narrowing the scope of the provision. It also uses the term "revenue" instead of "income," which similarly appears to narrow the scope, as discussed below.

accrues.[25] While section 451(b) is limited to taxpayers with applicable financial statements, such taxpayers constitute a large portion of the accrual-accounting universe. Thus, requiring taxpayers to include market discount in income as it accrues if they do so on an applicable financial statement would be tantamount to requiring the current inclusion in income of market discount for accrual method taxpayers. The omission of a specific market discount provision strongly suggests that Congress did not intend to change the treatment of market discount in the Act.

Given this history, the amendments to section 451(b) should not apply to discount that is treated as such for both book and tax purposes. In other words, section 451(b) should apply only to items that are treated as discount under the tax laws but as something other than discount for GAAP.

B. Interest and Discount on Debt Instruments Held for Investment Are Not "Revenue" for Book Purposes.

Section 451(b)(1) states that the all events test for an item of gross income is met no later than when that item is taken into account as *revenue* for financial accounting purposes. The use of the word "revenue" rather than "income" is not accidental. As noted above, Congress modeled section 451(b) as included in the Act on section 3303 of the Camp Bill. That version of section 451(b) used the term "income" rather than "revenue." The version of section 451(b) adopted by the Senate Finance Committee on November 16, 2017, contained language nearly identical to the Camp Bill.[26] The version passed by the whole Senate (and ultimately passed by both houses as the Act), however, changed the word "income" to "revenue."[27] This strongly suggests that Congress intentionally narrowed the scope of section 451(b). As discussed below, we believe that this change implies that Congress intended to limit section 451(b) to transactions with customers in the ordinary course of the taxpayer's active trade or business. Thus, as applied to debt instruments, use of the term "revenue" suggests that section 451(b) should not apply to discount on debt instruments held for investment.

Although not dispositive, Accounting Standards Codification (ASC) 606, entitled Revenue from Contracts with Customers, is helpful in determining the meaning of "revenue" under GAAP. ASC 606 defines the term "revenue" as "inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or

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[25] It is worth noting that the revenue estimate for the amendments to section 451(b) in the Act is significantly lower than the revenue estimate for the same provisions in the Camp Bill. This suggests that the amendments in the Act were not intended to include market discount, as that provision was scored separately in the Camp Bill. It also suggests that the scope of the provision in the Act is more limited than that in the Camp Bill. *See* Joint Committee on Taxation, Estimated Budget Effects of the Conference Agreement for H.R. 1, the "Tax Cuts and Jobs Act," JCX-67-17, Dec. 18, 2017; Joint Committee on Taxation, Estimated Revenue Effects of the "Tax Reform Act of 2014," JCX-20-14, Feb. 26, 2014.

[26] H.R. 1, 115th Cong. (as reported by S. Comm. on Finance, Nov. 16, 2017).

[27] H.R. 1, 115th Cong. (as passed by Senate, Dec. 2, 2017). *See also* 163 CONG. REC. S7599 (daily ed. Nov. 30, 2017) (S. Amend. 1735 of Sen. Rounds).

producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations."[28]

The definition of "revenue" in ASC 606 (which is the only one of general applicability in the ASC) is instructive in determining the scope of the term "revenue" for purposes of section 451(b), despite the specific exclusion of debt instruments from the scope of ASC 606.[29] As noted above, section 451(b) limits its application to items that would be "revenue" on an applicable financial statement. The title of ASC 606 (Revenue from Contracts with Customers) implies that items constitute "revenue" only if they are generated from contracts with customers. Further, the definition of revenue under ASC 606 is tied to income from delivering or producing goods, rendering services, or other major or central operating activities. Although there is no explicit guidance in the accounting literature, it seems a reasonable interpretation that the notion of major or central operating activities excludes activities that are passive in nature, such as investments in debt instruments (particularly in the secondary market) by RICs or other taxpayers.[30] Indeed, operating companies typically present any interest income from investments outside of "revenue" and after the presentation of "operating income" (i.e., revenue less cost of sales, less operating expenses) on financial statements.[31]

This interpretation of "revenue" is consistent with the primary purpose of section 451(b), which was to overrule legislatively *Capital One v. Comm'r* and IRS guidance on late fees and cash-advance fees. Fees that credit card companies (and other taxpayers in the lending business) charge are generated from contracts with customers or from their major or central operating activities and thus should be treated as revenue for purposes of section 451(b). Discount on a bond held by a passive investor, however, is not "revenue" for financial accounting purposes. The use of the term "revenue" thus suggests that section 451(b) does not apply to discount on debt instruments held for investment.

C. The Special Effective Date Rule for Instruments with OID without a Corresponding Rule for Market Discount Indicates that Congress Did Not Intend Section 451(b) to Override the Elective Nature of the Current Inclusion of Market Discount in Income.

The effective date rule in section 13221(e) of the Act for a debt instrument with OID provides that section 451(b) does not apply until tax years beginning after 2018. Congress did not include a corresponding rule for debt instruments with market discount. This suggests that

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[28] ASC 606-10-20.

[29] *See* ASC 606-10-15-2, which excludes receivables subject to ASC 310 and debt securities subject to ASC 320.

[30] We note that although RICs are subject to ASC 606, they do not have "revenue" for purposes of their financial statements. For financial reporting purposes, RICs only have "income" from dividends, interest, and securities lending, and gain or loss on their investments in securities. RICs do not actually charge service fees to their shareholders. Investment advisory and other fees are paid by a RIC to the investment management company or other service providers and are listed as "expenses" on the RIC's financial statements. *See* ASC 946-220-S99-1. Investment advisory fees paid by the RIC are included as "revenue" on the investment management company's financial statements.

[31] *See* ASC 220-10-S99-2 setting forth presentation of the income statement.

Congress did not intend for section 451(b) to change the treatment of market discount bonds. Further, if Treasury and the IRS were to interpret section 451(b) as applying to market discount as well as OID, this would produce the strange effect of making the rules effective in 2019 for debt instruments with both market discount and OID but effective in 2018 for debt instruments with market discount but no OID. This cannot be what Congress intended.[32]

IV. The Burden of Compliance with an Expansive Application of Section 451(b) Would Far Outweigh Any Benefits to the Government.

Financial accounting[33] and tax[34] both use yield-to-maturity principles in determining how interest (including OID) accrues. Therefore, any differences between book and tax accruals on a debt instrument (other than the threshold question of whether accrual is appropriate at all) are minor. The main difference between book and tax accruals is that tax has a *de minimis* rule for OID and market discount while book accounting has no such rule. When accrual on a yield basis is required for both book and tax, the differences generally relate to how book and tax treat puts and calls, prepayment contingencies (as on asset-backed securities), and contingent payments. While these differences generally result in faster accruals for tax purposes than for book purposes,[35] this is not true in all cases.

Consequently, the burden on taxpayers of having to apply section 451(b) to interest-accrual calculations on a debt instrument would far outweigh any benefit to the federal fisc. If section 451(b) were interpreted to apply to accruals on debt instruments, every taxpayer with an applicable financial statement would have to put in place a system to compare the book and tax accruals of every debt instrument it holds and adjust the tax accrual in any case in which the cumulative book accrual exceeds the cumulative tax accrual. The system also would have to reverse out any adjustment as the tax accrual "catches up" with the book accrual. The design and implementation of such systems would be costly to taxpayers and would produce negligible (if any) timing benefit to the federal government.

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[32] The Securities Industry and Financial Markets Association's Asset Management Group (SIFMA AMG) recently submitted a letter requesting similar clarification on the scope of section 451(b). *See* SIFMA AMG Letter addressed to Tom West and Bill Paul, dated April 27, 2018. Notably, SIFMA AMG requests that the Treasury and IRS delay the implementation of section 451(b) with respect to market discount and OID (if section 451(b) is broadly applied to cover such items) until the government issues guidance on the application of section 451(b). The ICI supports SIFMA AMG's request for a delay in the effective date, particularly given the additional guidance (as discussed in the SIFMA AMG letter) that would be necessary for RICs to implement a broad application of section 451(b).

[33] ASC Topic 310-20 (requiring the "interest method" for discount on debt "held to maturity"); ASC 835-30-35-2 (defining the interest method, in which discount or premium is "amortized as interest expense or income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period").

[34] Treas. Reg. §1.1272-1(b).

[35] For example, the tax regulations governing contingent payment debt instruments require accruals at the "comparable yield" on noncontingent debt instruments with similar terms and conditions, while book accruals are generally limited to the stated yield. The book and tax rules governing asset-backed securities are quite similar, but book generally results in slower accruals than tax when the performance of the security is better than originally projected.

Applying section 451(b) to market discount and traditional OID would be especially burdensome for RICs and other taxpayers with large portfolios. A typical bond portfolio for a fixed income fund could hold thousands of debt instrument positions with some type of discount. There currently is no automated system that permits RICs to compare the book and tax accruals, so initially it would have to be done manually. Building an automated system, if feasible, would be costly and time consuming, and any costs ultimately would be borne by a RIC's shareholders.

It also should also be noted that if section 451(b) is interpreted to override the OID and market discount *de minimis* rules, this will change not only the timing but also the character of the income from instruments with *de minimis* discount. Notwithstanding the potential application of amended section 451(b), *de minimis* discount is taken into account as additional gain (or reduced loss) when the debt instrument is sold or matures. It thus generally is taxable as capital gain if the debt instrument is a capital asset in the hands of the taxpayer, as it would be for RICs.[36] If the *de minimis* discount is recognized in income as it accrues, it is ordinary income, as capital character under section 1222 requires a sale or exchange (or, by virtue of section 1271, a redemption). We do not think that Congress intended section 451(b) to change the character of income. Therefore, this new provision should not be interpreted to override the OID and market discount *de minimis* rules.[37]

In particular, this change in character for *de minimis* market discount would impact municipal bond funds and their shareholders. Municipal bond funds typically do not elect to accrue market discount currently, and market discount on the municipal bonds held by the funds often is *de minimis*. Therefore, under prior law, these funds did not have ordinary income attributable to market discount, and any such discount was taxed as capital gain when the bonds were sold or matured. If amended section 451(b) applies to market discount and effectively overrides the *de minimis* rule, municipal bond funds would be forced to accrue market discount currently, resulting in ordinary income that must be distributed to the fund shareholders as taxable dividends. This could be a fundamental change to the funds' investment goals and the investors' expectations. It also could increase transaction costs, as the funds might need to sell assets to generate cash to pay the distributions.

The burdens that would be imposed on RICs, fund shareholders, and other taxpayers would far outweigh any additional revenue raised by requiring such a broad application of section 451(b). It is unclear what policy goal would be served; the associated costs would make any such goals even more untenable.

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[36] *See* Treas. Reg. §1.1273-1(d)(5)(ii).

[37] If interpreted broadly, section 451(b) can also result in a character difference for market discount that is not *de minimis.* If a market discount bond is sold at a gain that is less than the accrued market discount at the time of the sale, section 1276(a)(1) limits the amount of market discount includible as ordinary income to the gain on the sale. If section 451(b) is interpreted to require market discount to be included in income as it accrues for a taxpayer with an applicable financial statement, the taxpayer would have to include the entire amount of accrued market discount in income over the period during which it owned the debt instrument and would have a capital loss for the difference between the taxpayer's basis (which would then include the accrued market discount) and the amount realized on the sale. This also can occur if the taxpayer makes a section 1278(b) election but, in that case, the potential character change is at the election of the taxpayer.

V. Recommendation

ICI, as explained above, believes that section 451(b) does not override the statutory market discount rules. We also believe that Congress did not intend for the provisions to cover items that are treated as discount for both book and tax purposes. ICI thus asks the Treasury Department and the IRS to confirm that the amendments to section 451(b):

- Do not apply to market discount; and
- With respect to OID, are limited to credit card fees and other items that are treated as something other than discount for book purposes.

We appreciate your attention to our request. We will contact your offices shortly to schedule a meeting to further discuss these issues. In the meantime, please do not hesitate to contact me (202-371-5432 or kgibian@ici.org) if you have any questions.

Sincerely,

/s/ Karen L. Gibian

Karen Lau Gibian
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cc: Michael Novey
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