

Legislative Update: Select Financial Product Provisions in the Biden Administration's 2024 Revenue Proposals

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This article provides an overview of select proposals included in Treasury's *General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals* (the "Green Book"). The discussion focuses on provisions that would affect the taxation of financial products but does not attempt to provide an exhaustive analysis of all relevant provisions.¹ Instead, the discussion that follows will focus specifically on proposals affecting: (i) the stock repurchase excise tax; (ii) derivatives referencing partnerships that generate effectively connected income ("ECI"); (iii) digital asset mining; (iv) the wash sale rules; (v) the rules pertaining to securities lending arrangements; and (vi) the mark-to-market rules under Code Sec. 475. For interested readers, the full text of these proposals is included in an appendix to this article.

In the current Congress, the passage of a controversial tax legislation package is expected to be difficult. It is possible, however, that some more limited proposals may attract bipartisan support and could be included in near-term legislation, although there seems to be very little momentum to date. With that said, we believe the Green Book proposals still warrant comment because there has been a trend towards reusing previous budgetary proposals, and the provisions described below are likely to reappear in future legislation.

Stock Repurchase Excise Tax Increase

H.R. 5376 (commonly called the "Inflation Reduction Act") introduced a one-percent excise tax on repurchases of stock by certain publicly traded companies defined as "covered corporations" (generally domestic corporations with stock traded on an established securities market). "Repurchase" for these purposes is defined as a redemption within the meaning of Code Sec. 317(b), which generally includes any acquisition by a corporation of its stock from a

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shareholder in exchange for property other than its stock or rights to acquire its stock. The excise tax is imposed on the fair market value of stock repurchased (or treated as repurchased).²

Although the excise tax generally applies to a domestic corporation repurchasing its own stock, in some cases it may apply to domestic corporations purchasing foreign corporate stock. Specifically, if a U.S. “specified affiliate” of an “applicable foreign corporation” (generally speaking, a U.S. corporation or partnership that is more than 50 percent owned by a publicly traded foreign corporation) acquires stock of the applicable foreign corporation from a third party, the U.S. specified affiliate is treated as a covered corporation with regard to the acquisition, and the acquisition is treated as a repurchase of stock of a covered corporation by the covered corporation (a “Covered Foreign Stock Repurchase”).

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Notice 2023-2³ (the “Excise Tax Notice”) indicates that a Covered Foreign Stock Repurchase is treated as occurring if a U.S. specified affiliate funds by any means (including through distributions, debt, or capital contributions) the acquisition or repurchase of stock of the applicable foreign corporation, and such funding is undertaken for a principal purpose of avoiding the stock repurchase excise tax. The Excise Tax Notice also includes a “*per se* rule,” which indicates that a principal purpose of avoiding the excise tax is deemed to exist if the U.S. specified affiliate funds by any means, other than through distributions, the applicable foreign corporation (or another specified affiliate), and such funded entity acquires or repurchases stock of the applicable foreign corporation within two years of the funding (the “*Per Se* Rule”).

The *Per Se* Rule appears to have a broad reach. For example, the excise tax would be levied when an applicable foreign corporation repurchases its stock if there are intercompany funding or cash-pooling arrangements with U.S. subsidiaries in place within two years of the repurchase. This would appear to apply under the Excise Tax Notice even if such arrangements may have been put in place years ago for routine business reasons. For these and other reasons, the *Per Se* Rule has been the target of a significant amount of negative commentary.⁴

The Green Book proposal would increase the rate of tax imposed on stock repurchases to four percent for repurchases of stock after December 31, 2022. The Green Book estimates that the proposal would raise almost \$4 billion in 2023 and approximately \$238 billion between 2024 and 2033.

Stock repurchases or “buybacks” are reported to have reached a record \$1.2 trillion in 2022, and buyback announcements have continued at a record pace in the first quarter of 2023.⁵ This suggests that the one-percent stock repurchase excise tax has not significantly influenced corporate decision-making with respect to stock buybacks. The proposal, by increasing the cost of a stock buyback, may cause at least some corporations to re-evaluate their buyback plans (in line with the policy rationale for the stock repurchase excise tax). Alternatively, the increased rate may raise additional revenue from corporations that choose to implement stock buybacks.

The proposal would increase the rate of the stock repurchase excise tax but appears to otherwise leave the statutory provision unaffected. Thus, certain existing issues regarding the stock repurchase excise tax would remain and take on greater importance. In particular, the *Per Se* Rule would take on heightened significance if it were to be retained in temporary or final regulations and if the tax rate increases to four percent. It is therefore somewhat heartening to see reports that Treasury may be re-evaluating the *Per Se* Rule.⁶

Expansion of Code Sec. 871(m) to ECI Partnerships

Dividends paid by U.S. corporations to a foreign person are U.S.-sourced and, absent a reduction in rate or elimination of withholding under an income tax treaty, are subject to U.S. withholding taxes.⁷ However, prior to the enactment of Code Sec. 871(m) in 2010, payments made to a foreign person pursuant to a swap referencing U.S. corporate stock generally were not subject to U.S.

withholding tax.⁸ To prevent the avoidance of withholding on U.S.-source dividends by using derivative instruments, Code Sec. 871(m) was enacted to provide that “dividend equivalent” payments under certain equity swaps or other specified instruments or transactions relating to the stock of U.S. corporations are treated as U.S.-source income.⁹

Code Sec. 871(m) does not currently apply to all situations in which a derivative could be used to avoid U.S. withholding tax. A foreign taxpayer that invests in a U.S. partnership with ECI is required to file a U.S. tax return to report that income and pay tax on it. Some or all of the gain on the sale of an interest in a partnership that is engaged in the conduct of a U.S. trade or business may be treated as ECI by reference to a deemed sale of the partnership’s assets, and tax is required to be withheld on that gain. Thus, derivative instruments referencing an ECI-generating partnership (e.g., an oil and gas publicly traded partnership)¹⁰ could be used to avoid the tax and withholding on payments determined by reference to income or gain from a partnership interest that would be classified as ECI if received directly.

The Green Book proposal would seek to remedy this situation by imposing withholding tax on payments substituting for partnership ECI. The Green Book proposal contains less detail than the legislative text of a previous H.R. 5376 (the “Build Back Better Act”) proposal regarding the scope of derivative financial instruments covered and the payments subject to tax.¹¹ The proposal may be narrower than the Build Back Better Act proposal because it does not explicitly apply to gain on sale or exchange of derivative financial instruments and is limited to payments determined by reference to partnership ECI (potentially excluding payments that refer to income taxable to a foreign partner other than ECI). Like the Build Back Better Act proposal, the Green Book proposal provides regulatory authority to carry out the purposes of the section. In that regard, rules will likely be needed to ensure that publicly traded partnerships supply the necessary information to determine the amounts subject to withholding under the proposal.

Digital Asset Mining Energy Excise Tax

The process by which transactions on a blockchain are validated and recorded is referred to as a “consensus mechanism.” Very generally, there are two types of consensus

mechanisms—proof of work (“PoW”) and proof of stake (“PoS”).

Under a PoW system, “miners” compete to solve a cryptographic puzzle. The winning miner is given the right to validate transactions and add a new “block” to the “chain” of transactions (hence the term “blockchain”) and is given a reward in the form of newly created digital assets.¹² The cryptographic puzzle ties blockchain validation to real-world resources and protects the network by making various types of attacks prohibitively expensive.¹³ The difficulty of the cryptographic puzzle is adjusted periodically to maintain a consistent transaction cycle time (*i.e.*, if more computing power is attempting to solve the puzzle, the difficulty will increase; if the amount of computing power decreases, so too will the difficulty of the puzzle). The Bitcoin blockchain is the most significant blockchain that employs a PoW model.¹⁴ Under basic principles of supply and demand, the high market value of bitcoin means that a significant amount of computing power is allocated to mining. This results in very difficult cryptographic puzzles and significant computational and energy costs (Bitcoin’s energy usage is comparable to the total energy usage of some countries).¹⁵

Under a PoS system, the real-world costs imposed by mining are eliminated. Instead, the blockchain requires that validators post or “stake” digital assets in exchange for a chance at being selected to validate the next block and be rewarded with new digital assets (the chances of being selected increase with the size of the stake). PoS blockchains are secured by a “slashing” mechanism whereby stakers may lose their staked assets if they behave in a manner detrimental to the network. Because there is no mining under a PoS system, PoS networks avoid the hardware and energy costs incurred under a PoW system.¹⁶

To address perceived negative environmental externalities, the Green Book would impose a 30-percent excise tax on the cost of electricity used in digital asset mining.¹⁷ Firms engaged in digital asset mining would be required to report the amount and type of electricity used as well as the value of that electricity, if purchased externally. Firms that lease computational capacity would be required to report the value of the electricity used by the lessor firm attributable to the leased capacity, which would serve as the tax base. Firms that produce or acquire power off-grid, for example, by using the output of a particular electricity generating plant, would be subject to an excise tax equal to 30 percent of estimated electricity costs.

Because the excise tax would only apply to PoW blockchains, it would seem to create an incentive in favor of PoS consensus systems. Whether this is a good or bad thing is a matter of perspective, as the PoW and PoS consensus systems present trade-offs, and one is not universally accepted as superior.¹⁸

Notwithstanding the technical issues that must be worked through, the proposal sets forth a framework that most practitioners would agree with.

It is not clear that the excise tax would discourage environmentally damaging behaviors. As noted previously, the difficulty (and energy intensiveness) of digital asset mining is driven largely by the price of bitcoin. Bitcoin prices are (i) (generally) relatively uniform price across the global market; (ii) highly volatile; and (iii) predominately driven by factors other than the marginal cost of mining bitcoin in a particular jurisdiction. Therefore, increases in the marginal cost of mining in the United States will not necessarily translate into a fall in the price of bitcoin or a reduction in the overall environmental cost of securing the Bitcoin blockchain.

Perhaps more concerning, it is possible that the excise tax would actually increase the environmental costs of the digital asset mining industry. The United States currently hosts a significant amount of the world's PoW mining power, and the United States has comparatively cleaner forms of energy production than many other countries.¹⁹ Mining capacity has proved to be remarkably mobile,²⁰ and it is possible that imposing an excise tax in the United States would drive mining offshore (and possibly to jurisdictions where the prevailing forms of energy production are more environmentally destructive).²¹

As many have noted, there are industries with energy usage comparative to digital asset mining that would not be subject to an energy excise tax. If environmental concerns are truly the driver of the excise tax, arguably, it should be industry-neutral and apply broadly to all industrial energy use.²²

Our final comment is administrative. Although a large portion of digital asset mining is conducted by businesses with professionalized operations, there are also a significant

number of individuals who mine. The provision would technically apply to such individuals, but enforcement would be quite difficult because those individuals may not have a ready means of separating mining energy usage from personal use, and the government would have a limited ability to identify individuals who should be subject to the tax.

Expansion and Modification of the Wash Sale Rules

Under the wash sale rules of Code Sec. 1091(a), taxpayers who sell stock or securities at a loss are generally prohibited from recognizing the loss if they acquire substantially identical stock or securities within a specified “window period” that begins 30 days before the sale and ends 30 days after the sale. If the wash sale rules apply, the disallowed loss is preserved through the application of special basis and holding period rules that tack the basis and holding period of the stock or security that was sold to the replacement stock or security.²³

The Internal Revenue Service (“IRS”) has ruled that commodities²⁴ and foreign currencies²⁵ are not securities subject to the wash sale rules. There is also general agreement among commentators that digital assets are not subject to the wash sale rules under current law, for the reasons discussed in *Cryptocurrencies and the Definition of a Security for Code Sec. 1091*, JOURNAL OF TAXATION OF FINANCIAL PRODUCTS, Vol 18, No. 2 (2021).

The IRS has taken the position that a loss from a sale of stock or securities by an individual taxpayer is subject to Code Sec. 1091 if the taxpayer's individual retirement account (“IRA”) or Roth IRA purchases substantially identical stock or securities within 30 days of the sale.²⁶ However, it is far from clear that the IRS position is the better view of the law as it stands today, as described in *Related-Party Wash Sale Transactions—An Evaluation of the Current State of the Law and Recent Legislative Proposals*, JOURNAL OF TAXATION OF FINANCIAL PRODUCTS, Vol. 19, No. 2 (2022).

The Green Book proposal would implement certain related party loss disallowance rules as well as expand the scope of the wash sale rules to cover additional asset classes. The general thrust of the Green Book proposal is similar to that of Sec. 138152 of the Build Back Better Act but with several key differences.

In the Build Back Better Act proposal, the wash sale rules would have been expanded to cover digital assets as well as any security (as defined by Code Sec. 475(c)(2)),

any foreign currency, and any commodity (as defined by Code Sec. 475(e)(2)).²⁷ In contrast, the Green Book proposal would expand the scope of the wash sale rules to cover digital assets and provide regulatory authority to the Secretary to treat any security as defined by Code Sec. 475(c)(2), or any commodity as defined by Code Sec. 475(e)(2), or other assets traded on an established market as subject to the wash sale rules as necessary to prevent abuse. Depending on how Treasury exercises its regulatory authority, the Green Book proposal could be somewhat narrower than the previous Build Back Better Act proposal (because securities, commodities, and foreign currencies are not covered in the absence of regulations to that effect) or broader (because the Build Back Better Act proposal did not provide broad regulatory authority to subject “other assets traded on an established market” to the wash sale rules).

A second difference pertains to an exception for ordinary course business transactions. In the Green Book, this exception would apply to digital assets, whereas in the Build Back Better Act proposal business needs and hedging exceptions were included only for commodity and foreign currency transactions.²⁸

The third difference is in the structure of the related party rules. Under the Build Back Better Act proposal, losses would have been disallowed if a related party acquired a replacement position within the wash sale window.²⁹ Because the government was concerned that this rule could enable loss importation strategies, basis tacking was proposed to be allowed only in situations where the taxpayer or the taxpayer’s spouse acquired a replacement position. This proposed restriction on tacking created the odd result that unwary taxpayers could suffer a permanent loss of basis, whereas well-advised taxpayers could use this rule to their advantage to circumvent the wash sale rules.³⁰ Another perceived flaw in the Build Back Better Act proposal was that it did not explicitly provide for an adjustment to the holding period in the case of a related party wash sale.

These shortcomings appear to have been addressed in the Green Book proposal, under which disallowed losses would be deferred until the related party sells or otherwise disposes of the asset, provided that the taxpayer and a related party do not reacquire the asset within 30 days before or after that sale or disposition, or the parties cease to be related. Thus, there would be reduced potential for a permanent basis loss, and the wash sale rules would not be able to be easily avoided through related party transactions. This is consistent with the recommendations of some commentators.³¹

Under current law, the treatment of certain derivative transactions under the wash sale rules is not entirely clear. For example, the tax community is divided on whether certain derivative instruments, such as total return swaps, should be treated as a contract or option to acquire the underlying stock or security.³² In addition, it is not clear from the statutory language of the basis tacking rules how basis from the sale of a stock or security tacks to an option contract that triggers a wash sale.³³ The Green Book states that “the wash sale rules also would be amended to address derivative financial instruments more comprehensively, including modifications to the basis rules to prevent abuse.” It is not clear entirely what the drafters have in mind, but it could potentially touch on the issues described above.

The Green Book proposal states that “[n]o inference is intended as to whether the losses claimed by taxpayers from wash sales of digital assets may be deducted under current law, or as to the proper treatment of transactions involving related parties under the wash sale rules under current law.” This is slightly different from the language in the House-passed Build Back Better Act, which did not indicate that no inference was intended with respect to the treatment of digital assets under the wash sale rules.³⁴

Similar to current law, the Green Book would require brokers reporting a customer’s adjusted basis on a disposition of a digital asset or other asset subject to the wash sale rules to report the basis of the asset without regard to the wash sale rules unless the sale of the loss asset and the transaction causing the wash sale rules to apply occurs in the same account with respect to identical assets. Given the changes caused by the related party rules, the divergence between broker reporting of wash sales and the substantive wash sale rules would be increased. However, the Green Book would also provide the Secretary with authority to require brokers to report such information as may be necessary or appropriate to implement the wash sale rules, and it is possible that this authority would be used to better align broker reporting with the substantive rules.

Expansion and Modification of Code Sec. 1058

Securities lending transactions are commonly used to increase the yield on holding security and are an integral part of the “plumbing” of the capital markets. In the typical securities lending transaction, the securities

owner will lend securities to a counterparty under an agreement providing for the return of identical securities upon demand. The securities borrower is also required to pay a “borrow fee” and make “in lieu payments” (*i.e.*, payments equivalent to any dividends, interest, or other payments received on the security being lent). Securities loans are typically collateralized, with the security lender paying a rebate fee on the collateral posted.³⁵ The securities borrower typically has the right to dispose of the borrowed security and often borrows the security expressly for that purpose (*e.g.*, to enter into a short sale transaction).

Under current law, no gain or loss is recognized if the transfer of a security is pursuant to an agreement that meets certain requirements under Code Sec. 1058.³⁶ Gain or loss also is not recognized on the return of that security in exchange for rights under the agreement.³⁷ For this purpose, the term “securities” is defined by reference to Code Sec. 1236(c) and includes corporate stock, notes, bonds, debentures and other evidence of indebtedness, and any evidence of an interest in or right to purchase any of the foregoing.³⁸

Proposed Reg. §1.1058-1(b)(3) provides that an agreement is subject to nonrecognition treatment under Code Sec. 1058 only if it provides that the lender may terminate the loan upon notice of not more than five business days. Under this proposed regulation, any securities loan with a fixed duration would be a taxable disposition of the security being loaned.³⁹ Outside of certain abusive transactions, there seems to be very little policy justification for this result, and purposely “defective” securities loans have been used by taxpayers to trigger gains or losses without divesting of the economics of an underlying position.

The capital markets have changed significantly from when Code Sec. 1058 was enacted in 1978 and the proposed regulations were published in 1983. Since that time, the variety of assets and the volume of trading in such assets that are not clearly subject to Code Sec. 1058 have both increased greatly. For example, taxpayers seeking to increase yields will frequently lend digital assets or publicly traded partnership interests in transactions that look similar to customary securities lending transactions. These transactions are not within the scope of Code Sec. 1058 because digital assets and partnership interests are not “securities” as defined by Code Sec. 1236(c).⁴⁰ Although it could be argued that Code Sec. 1058 is a safe harbor provision rather than the sole means of achieving nonrecognition,⁴¹ the proposed regulations could be read to suggest otherwise.⁴² For a detailed discussion of the

arguments for and against recognition in the context of digital asset loans, see *Cryptocurrency Loans—Taxable or Not?*, JOURNAL OF TAXATION OF FINANCIAL PRODUCTS, Vol. 17, No. 1 (2020).⁴³

Another area of uncertainty with securities lending arrangements is the treatment of in lieu payments. If a taxpayer holds a bond issued at a discount, the taxpayer is generally required to accrue the discount over the term of the debt using a constant yield to maturity. In several tax-motivated transactions, taxpayers took the position that accrual of discount on a debt instrument was not required when the debt instrument was loaned. If these transactions had worked as intended, the taxpayer would have been able to defer income and convert the income from ordinary interest accruals to capital gain. The taxpayers lost, but the underlying issue of accrual methodology is also relevant to non-abusive transactions and is an area of significant uncertainty. On the other hand, not every payment on a bond or stock is taxable. Should in lieu payments in respect of principal payments or non-dividend distributions be taxed when they would not be if the underlying instrument were held directly? The law is not entirely clear.⁴⁴

The Green Book proposal would expand the securities loan nonrecognition rules to include loans of actively traded digital assets recorded on cryptographically secured distributed ledgers, if such loans have terms similar to those currently required for loans of securities. For example, if during the term of a loan the owner of the digital asset would have received other digital assets or other amounts if the loan had not taken place, the terms of the loan agreement should provide that those amounts will be transferred by the borrower to the lender. Additionally, the proposal would require that income that would be taken into account by the lender if the lender had continued to hold the loaned asset must be taken into account by the lender in a manner that clearly reflects income. The proposal would provide for appropriate basis adjustments to the loan contract and when the loaned asset is returned. The proposal would also clarify that fixed-term loans are subject to the securities loan nonrecognition rules if they would otherwise qualify. The proposal would be effective for tax years beginning after December 31, 2023, and provides that no inference is intended regarding the treatment of digital asset loans, publicly traded partnership interest loans, and fixed-term securities loans under current law.

The various elements of this proposal would go a long way toward easing some of the uncertainty in this complex area and provide a much-needed overhaul of an antiquated statute. But the devil will be in the details. For example, the

barriers to a given individual or entity creating a new digital asset through a hard fork are almost non-existent, but most new digital assets never achieve market acceptance. In recognition of this fact, most digital asset loans provide for in kind in lieu payments of hard fork currencies only in situations where the new digital asset is economically meaningful. These arrangements are certainly within the “spirit” of Code Sec. 1058 and ought to be given non-recognition treatment. However, drawing definitive lines as to what does and does not qualify is always difficult. In this regard, prevailing market practice might serve as the best guide.

Publicly traded partnership interests also pose their own special issues. In the case of a partnership, income is taxed at the partner level on an annual basis, and distributions are generally not subject to tax. Should the lender be put back in a similar position as if they owned the partnership directly? If so, how would the lender obtain the necessary information to determine its income?

Notwithstanding the technical issues that must be worked through, the proposal sets forth a framework that most practitioners would agree with.

Expansion of Code Sec. 475 to Digital Asset Dealers and Traders

Code Sec. 475 requires dealers in securities to use the mark-to-market method of accounting for inventory and non-inventory securities held at year end.⁴⁵ Gain or loss recognized under this mark-to-market method of accounting is generally characterized as ordinary gain or loss.⁴⁶ For purposes of Code Sec. 475, a “security” includes corporate stock, interests in widely held or publicly traded partnerships and trusts, debt instruments, and certain derivative financial instruments.⁴⁷ Although the IRS has taken the position that digital assets are property for federal income tax purposes,⁴⁸ as of yet, no guidance has been issued on the question of whether any particular digital asset is a “security” for purposes of Code Sec. 475. Nevertheless, many practitioners take the position that digital assets are not securities, as defined by Code Sec. 475(c)(2).⁴⁹

Dealers in commodities and traders in securities or commodities may elect to use the mark-to-market method of accounting.⁵⁰ For this purpose, Code Sec. 475(e)(2)(A) defines the term “commodity” to include “any commodity which is actively traded.”⁵¹ Thus, there are two requirements—an asset must be (i) a commodity and (ii) actively traded. Under current law, it is not entirely clear whether digital assets meet this definition.⁵²

With respect to the first requirement, Code Sec. 475(e)(2)(A) does not attempt to define the term “commodity” in general. In similar self-referential situations where the term being defined is used in the definition, the courts have generally held that an item must fit within the common understanding of the term to fall within the definition.⁵³ In common parlance, the term “commodity” generally connotes fungibility with other assets of a similar class and grade. Many digital assets satisfy this requirement.⁵⁴ However, the term commodity might also impart a tangible asset connotation, which arguably would not be satisfied by digital assets.⁵⁵

With respect to the requirement that the commodity must be actively traded, the statute cross-references Code Sec. 1092(d)(1). Futures on ether and bitcoin are traded on the Chicago Mercantile Exchange (a Commodities Futures Trading Commission-regulated commodities exchange), but other digital assets are not similarly traded. Although not entirely clear, most practitioners believe mainstream digital assets are actively traded because the exchange on which they trade operates similar to a traditional commodities exchange.⁵⁶

The Green Book proposal would add a third category of assets—“actively traded” digital assets and derivatives on, or hedges of, those digital assets—that may be marked to market at the election of a dealer or trader in those assets. The IRS would have the authority to determine which digital assets are treated as actively traded. The determination of whether a digital asset is actively traded would take into account relevant facts and circumstances, which may include whether the asset is regularly bought and sold for U.S. dollars or other fiat currencies, the volume of trading of the asset on exchanges that have reliable valuations, and the availability of reliable price quotations.

A digital asset would not be treated as a security or commodity for purposes of the mark-to-market rules and would therefore be eligible for mark-to-market treatment only under the rules applicable to this new category of assets. This would allow taxpayers a greater degree of flexibility in determining whether to apply the mark-to-market method of accounting. More specifically, a taxpayer that trades in both digital assets and commodities could elect mark-to-market accounting for digital assets but not commodities, or *vice versa*.

The potential availability of a mark-to-market method of accounting for digital assets would be useful for a variety of reasons. Mark-to-market accounting generally provides a clear reflection of income with respect to assets that are traded in established markets, and for financial accounting purposes, taxpayers may be required to mark

inventory or trading positions to market. Allowing taxpayers to use their financial accounting valuations for tax purposes may reduce tax compliance costs. Also, if a digital asset wash sale or constructive sale provision is enacted in the future, the mark-to-market method of accounting would mitigate the impact of those provisions (it would also be helpful for digital asset straddle positions, which are arguably already subject to the loss deferral, capitalization, and special holding period rules under Code Secs. 263(g) and 1092).

Conclusion

The Green Book would make several novel changes to the taxation of financial products but would fall short of a widespread overhaul. The Green Book proposals showed thoughtful improvements over previous proposals, and certain proposals would go a long way toward clarifying uncertainties under current law. Although the Green Book proposals are unlikely to become law any time soon, we will likely see similar proposals again in the future.

APPENDIX. GREEN BOOK PROPOSALS

Increase the Excise Tax Rate on Repurchase of Corporate Stock

Current Law

The stock repurchase excise tax applies at a rate of one percent of the fair market value (FMV) of any stock of a covered corporation that is repurchased by the corporation during its taxable year. The statute generally defines a “covered corporation” as a domestic corporation whose stock is publicly traded on an established securities market. An established securities market for this purpose includes U.S. national securities exchanges, certain foreign securities exchanges, regional or local exchanges, and certain interdealer quotation systems. “Repurchases” include a corporation’s acquisition of any of its stock from a shareholder for property that qualifies as a redemption of the stock as defined in the Internal Revenue Code. The statute also provides that a repurchase includes any other transaction that the Secretary or her delegates determines in regulations or other guidance to be “economically similar” to a redemption of stock. A repurchase also may include acquisitions of the corporation’s stock by certain specified affiliates. The annual FMV of a covered corporation’s repurchased stock is reduced by certain exceptions and reductions, including the FMV of the covered corporation’s stock that is issued or provided to employees during the taxable year. The stock repurchase excise tax also applies to certain subsidiaries of foreign corporations, as well as certain non-U.S. corporations subject to the inversion rules.

Reasons for Change

Stock repurchases are tax-favored relative to dividends as a means of distributing corporate profits to shareholders.

Increasing the excise tax rate on stock repurchases would reduce this disparity. Moreover, raising the tax rate is an administratively simple and progressive way to raise revenue to pay for the Administration’s fiscal priorities.

Proposal

The proposal would increase the tax rate on corporate stock repurchases to 4 percent. The proposal would apply to repurchases of stock after December 31, 2022.

Treat Payments Substituting for Partnership Effectively Connected Income as U.S. Source Dividends

Current Law

A foreign taxpayer that invests in a U.S. partnership with income effectively connected to the conduct of a trade or business (ECI) is required to file a U.S. tax return to report that income and pay tax on it. Some or all of the gain on the sale of an interest in a partnership that is engaged in the conduct of a U.S. trade or business may be treated as ECI by reference to a deemed sale of the partnership’s assets, and tax is required to be withheld on that gain.

For certain purposes, including the U.S. withholding tax rules applicable to foreign persons, a dividend equivalent is treated as a dividend from U.S. sources. A dividend equivalent is any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the U.S. Any payment made under a specified notional principal contract, or made under an equity-linked instrument that meets certain criteria, that directly or indirectly is contingent upon, or determined by reference to, the payment of

a dividend from sources within the U.S. also is treated as a dividend equivalent.

In the case of a dividend equivalent payment made by a foreign person to a foreign person, the jurisdiction of the foreign person making the payment may not treat the payment as a U.S. source dividend subject to U.S. taxation. As a result, the foreign person making the payment may be subject to different and potentially conflicting obligations under U.S. law and foreign law.

Reasons for Change

Foreign taxpayers may take the position that the rules requiring reporting and payment of tax on investments in U.S. partnerships do not apply if the foreign taxpayer acquires an economic interest in a publicly traded partnership with ECI through a derivative financial instrument, such as a total return swap, and that the payments on the financial instrument that are received by the foreign taxpayer are foreign source payments. Foreign taxpayers may also take the position that the rules requiring withholding on dividend equivalent payments do not apply to payments on the financial instrument or apply only to a small portion of those payments. As a result, taxpayers can readily avoid the imposition of U.S. tax on ECI from an investment in a partnership with a U.S. trade or business.

Proposal

The proposal would treat the portion of a payment on a derivative financial instrument (including a securities loan or sale-and-repurchase agreement) that is contingent on income or gain from a publicly traded partnership or other partnership specified by the Secretary or her delegates (Secretary) as a dividend equivalent, to the extent that the related income or gain would have been treated as ECI if the taxpayer held the underlying partnership interest.

The Secretary would have authority to prescribe such regulations or other guidance as may be necessary or appropriate to carry out the purposes of, and prevent the avoidance of, this section, including with respect to payments made between foreign persons.

No inference is intended as to the application of current law to derivative transactions on interests in partnerships with ECI.

The proposal would be effective for taxable years starting December 31, 2023.

Impose Digital Asset Mining Energy Excise Tax

Current Law

Current law does not provide tax rules specifically addressing digital assets, with the exception of certain rules relating to broker reporting and reporting of cash transactions.

Reasons for Change

Digital asset mining is a process for validating transactions among holders of digital assets to record and transfer cryptographically secured assets on a distributed ledger by, for example, using high-powered computers to perform calculations to select the validator.

The computational effort involved in mining can be substantial and can therefore require a correspondingly large amount of energy. The increase in energy consumption attributable to the growth of digital asset mining has negative environmental effects and can have environmental justice implications as well as increase energy prices for those that share an electricity grid with digital asset miners. Digital asset mining also creates uncertainty and risks to local utilities and communities, as mining activity is highly variable and highly mobile.

An excise tax on electricity usage by digital asset miners could reduce mining activity along with its associated environmental impacts and other harms.

Proposal

Any firm using computing resources, whether owned by the firm or leased from others, to mine digital assets would be subject to an excise tax equal to 30 percent of the costs of electricity used in digital asset mining.

Firms engaged in digital asset mining would be required to report the amount and type of electricity used as well as the value of that electricity, if purchased externally. Firms that lease computational capacity would be required to report the value of the electricity used by the lessor firm attributable to the leased capacity, which would serve as the tax base. Firms that produce or acquire power off-grid, for example by using the output of a particular electricity generating plant, would be subject to an excise tax equal to 30 percent of estimated electricity costs.

Except as otherwise provided by the Secretary, the term “digital asset” means any digital representation of value which is recorded on a cryptographically secured

APPENDIX. GREEN BOOK PROPOSALS (Cont'd)

distributed ledger or any similar technology as specified by the Secretary.

The proposal would be effective for taxable years beginning after December 31, 2023. The excise tax would be phased in over three years at a rate of 10 percent in the first year, 20 percent in the second, and 30 percent thereafter.

Apply the Wash Sale Rules to Digital Assets and Address Related Party Transactions

Current Law

Section 1091 of the Internal Revenue Code disallows a loss from a sale of stock or securities if the same or substantially identical stock or securities are purchased within 30 days before or after the sale (a “wash sale”) unless the taxpayer is a dealer in stock or securities and the loss is sustained in the ordinary course of its dealer business. If the stock or securities are purchased at a price that differs from the sale price of the stock or securities sold, appropriate adjustments are made to the basis of the purchased stock or securities. The holding period for the purchased stock or securities takes into account the holding period for the sold stock or securities. As a result, the effect of the wash sale rules ordinarily is to defer the recognition of a loss until the taxpayer finally disposes of the stock or securities. The wash sale rules also apply to sales of stock or securities where the taxpayer enters into a contract or option to buy the same or substantially identical stock or securities within the 30-day window, and to certain short sales of stock or securities. The wash sales are intended to ensure that taxpayers cannot recognize losses without exiting their position in a loss asset for a meaningful period of time.

The Internal Revenue Service treats a loss from a sale of stock or securities by a taxpayer that causes its individual retirement account or Roth IRA to purchase substantially identical stock or securities within 30 days of the sale as subject to the wash sale rule.¹

Except as otherwise provided by the Secretary or her delegates (Secretary), brokers who report gross proceeds and basis from the sale of stock or securities determine a customer's adjusted basis without regard to the wash sale rules, unless the transaction occurs in the same account with respect to identical securities.

Reasons for Change

Taxpayers with loss positions in digital assets are engaging in transactions that would be subject to the wash sale rules if

the digital assets were subject to section 1091. For example, a taxpayer may sell a digital asset that is not considered a stock or security for wash sale purposes at a loss on one day and repurchase the same digital asset the next day. The same loss recognition rules should apply to digital assets held as investments or for trading as would apply for stocks and securities.

The wash sale rules should also be updated to provide statutory rules addressing related party transactions, and to reflect new types of financial instruments that have developed since the last amendments made to those rules.

Broker reporting rules should be amended to reflect these changes to the wash sale rules.

Proposal

The wash sales rules would be amended to add digital assets to the list of assets subject to the wash sale rules. Except as otherwise provided by the Secretary, the term “digital asset” means any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary.² Regulatory authority would be granted to the Secretary to treat any security as defined by section 475(c)(2), or any commodity as defined by section 475(e)(2), or other assets traded on an established market as subject to the wash sale rules as necessary to prevent abuse. The basis and holding period rules applicable to purchased assets would be revised to reflect the expanded scope of the wash sale rules. These expanded rules are not intended to apply to ordinary course business transactions. The Secretary would have authority to prescribe regulations defining the term “substantially identical” and to provide an exception to the application of the wash sale rules for ordinary course business transactions (not including trading) involving digital assets.

The wash sale rules, as they apply to all assets and not only digital assets, would be modified with respect to transactions involving related persons, except as otherwise provided in regulations prescribed by the Secretary. In the case of any loss from a sale of assets subject to the wash sale rules and a purchase by a related party of the same or substantially identical assets within 30 days of the sale, the loss would be deferred until the related party sells or otherwise disposes of the asset or such other time as specified by the Secretary, provided that the taxpayer and a related party do not reacquire the asset within 30 days before or after that sale or disposition, or the parties cease to be related. A related party would include members of a taxpayer's family and tax-favored accounts such as individual retirement

accounts controlled by the taxpayer or the taxpayer's spouse. Two entities would be related to each other if one controlled the other, directly, or indirectly, or both were under the common control of either a third entity or the taxpayer and one or more family members. An individual would be related to an entity if the entity is controlled, directly or indirectly, by the individual and the individual's family members. The Secretary would have authority to issue regulations expanding this definition as necessary to prevent abuse, to provide rules for transactions where a taxpayer sold assets at a loss and both the taxpayer and a related party acquired the same or substantially similar assets, and to coordinate the operation of the wash sale rules with other rules dealing with sales of loss property between related parties (sections 267 and 707).

The wash sale rules also would be amended to address derivative financial instruments more comprehensively, including modifications to the basis rules to prevent abuse. The Secretary would have authority to require brokers to report such information as may be necessary or appropriate to implement the wash sale rules. Except as otherwise provided by the Secretary, brokers reporting a customer's adjusted basis on a disposition of a digital asset or other asset subject to the wash sale rules would report the basis of the asset without regard to the wash sale rules unless the sale of the loss asset and the transaction causing the wash sale rules to apply occur in the same account with respect to identical assets.

No inference is intended as to whether the losses claimed by taxpayers from wash sales of digital assets may be deducted under current law, or as to the proper treatment of transactions involving related parties under the wash sale rules under current law.

The proposal would be effective for taxable years beginning after December 31, 2023.

Modernize Rules Treating Loans of Securities as Tax-Free to Include Other Asset Classes and Address Income Inclusion

Current Law

A common transaction in the securities market is a loan of securities. Owners of securities such as pension plans, mutual funds, insurance companies and other institutional investors lend their securities because they receive compensation for doing so. Persons wishing to take a trading position in the security (for example, to short the security

as a hedge of another position or in order to benefit from an anticipated fall in price) will borrow the security in order to affect their transaction.

Loans of securities of this kind ordinarily are treated as transactions in which no gain or loss is recognized (nonrecognition treatment) if the transfer of a security is pursuant to an agreement that meets certain requirements. Gain or loss also is not recognized on the return of that security in exchange for rights under the agreement. The agreement must (a) provide for the return to the transferor of securities identical to the securities transferred; (b) require that payments be made to the transferor of amounts equal to all interest, dividends and distributions on the security during the term of the securities loan; (c) not reduce the risk of loss or opportunity for gain of the transferor in the transferred securities; and (d) meet such other requirements as the Secretary or her delegates (Secretary) may prescribe. These rules are intended to ensure that the taxpayer making the loan of securities remains in an economic and tax position similar to the position it would have been in absent the loan. For this purpose, the term "securities" means corporate stock, notes, bonds, debentures and other evidence of indebtedness, and any evidence of an interest in or right to purchase any of the foregoing. The basis of property acquired by a taxpayer in a securities loan when the securities are returned to the taxpayer is the same as the basis of the property loaned by the taxpayer.

Several court cases have ruled that these securities loan nonrecognition rules do not apply to a number of tax-motivated transactions denominated as securities loans with non-market-standard terms, and that the transactions gave rise to taxable gain or loss on the transfer of the security.³ While it is common in the securities lending market for a loan of securities to have a fixed term, in these cases, the security was loaned for a fixed or quasi-fixed term of unusually long duration, among other non-market-standard terms. In one case, the loaned security was a debt instrument that did not have coupons but was issued with significant original issue discount. The taxpayer did not take any amounts in respect of the accruing original issue discount into account during the term of the securities loan.⁴

Reasons for Change

The market for lending of financial and other assets has expanded over time to include digital assets and interests in publicly traded partnerships. The securities loan nonrecognition rules should be amended to take this expansion into account.

APPENDIX. GREEN BOOK PROPOSALS (Cont'd)

Since these rules are intended to ensure that the taxpayer making the loan of securities remains in an economic and tax position similar to the position it would have been in absent the loan, the rules should be further amended to ensure that taxpayers take income from a loan of an asset into account in a manner comparable to the income the taxpayer would have had if it had continued to hold the asset. First, taxpayers should be required to take income accruing on the asset into account as they would do absent the loan. Second, taxpayers should not be able to use securities loans to accelerate gains simply because the term of the loan is fixed.

Expansion of Asset Classes

In recent years, a market for the lending of digital assets recorded on cryptographically secured distributed ledgers has developed, and it is now growing rapidly. Similar to the securities lending market, owners of these digital assets may lend them in order to receive compensation for doing so. These loans' yields, as a share of the underlying value of the loaned assets, may be substantially higher than the interest received on loans of cash. Other taxpayers borrow these digital assets in order to carry out various trading strategies, to take speculative positions in those assets, or to use those assets as collateral for other transactions. The borrower of a digital asset may therefore dispose of it in order to carry out its trade, at which point neither the lender nor the borrower holds the digital asset.

Except in the case of digital assets that may also be treated as securities within the meaning of the definition described above, the securities loan nonrecognition rules do not apply to loans of digital assets. No other authority expressly addresses whether loans of assets other than securities give rise to taxable gain or loss. In light of the growing volume of loans of digital assets, rules addressing those transactions should be provided. Those rules should take into account differences between digital assets and securities. One example of those differences is that digital assets typically do not pay dividends or interest, but ownership of digital assets may result in other types of transfers of property to the owner such as hard forks⁵ and airdrops.⁶

Another type of financial asset that taxpayers may lend, including pursuant to the terms of brokerage agreements, are equity interests in publicly traded partnerships. Although these equity interests function like securities for non-tax purposes, they are not securities for purposes of the securities loan nonrecognition rules. No rules address how such loans are treated, or how the partnership income that would be taken into account by the partner absent the loan is treated.

The Secretary should have authority to treat such loans as tax-free if the resulting treatment of partnership income is appropriate.

Inclusion of Income from Loans of Assets

The securities loan nonrecognition rules do not address how the lender of a security that accrues interest or other income during the term of the loan should take that interest or other income into account. If the lender of the security is an accrual method taxpayer but that lender does not take income on the securities loan into account in respect of the interest or other income accruing on the underlying security, income to the lender would be deferred compared to the timing of income if the lender had not loaned the security. Lenders of assets should be required to include income during the term of the loan in a manner comparable to the income inclusions they would have absent the loan.

Some taxpayers treat fixed-term securities loans as within the scope of the securities loan nonrecognition rules. Based on the cases described above, other taxpayers are engaging in short-term fixed-term securities loans for the purpose of generating gains that are used to refresh expiring net operating losses or to give rise to future ordinary deductions. The borrowers in these transactions may have no business reason to borrow these securities other than to accommodate the lender. While a fixed term may indicate that a loan of an asset is a tax-motivated transaction, a fixed term of a duration customary in the market does not by itself substantially change a taxpayer's economic position. Taxpayers should not be able to use such transactions to accelerate gains.

Proposal

The proposal would amend the securities loan nonrecognition rules to provide that they apply to loans of actively traded digital assets recorded on cryptographically secured distributed ledgers, provided that the loan has terms similar to those currently required for loans of securities. For example, if during the term of a loan the owner of the digital asset would have received other digital assets or other amounts if the loan had not taken place, the terms of the loan agreement should provide that those amounts will be transferred by the borrower to the lender, except as provided by the Secretary. The Secretary would have authority to determine when a digital asset is actively traded, and the authority to extend the rules to non-actively traded digital assets. The proposal also would provide authority to the Secretary to extend the securities loan nonrecognition rules to other assets such as interests in publicly traded partnerships.

The proposal would require that income that would be taken into account by the lender if the lender had continued to hold the loaned asset must be taken into account by the lender in a manner that clearly reflects income. The proposal would provide for appropriate basis adjustments to the loan contract and when the loaned asset is returned.

The proposal would clarify that fixed-term loans are subject to the securities loan nonrecognition rules if they would otherwise qualify, except as provided by the Secretary. For example, fixed-term loans entered into in the normal course of a securities lending business, or the ordinary management of an investment portfolio ordinarily should be treated as nonrecognition transactions, while a loan of a security for all or virtually all of its remaining term or an accommodation loan entered into to generate tax benefits should not be treated as a qualifying loan.

No inference would be intended regarding the treatment of loans of digital assets or equity interests in publicly traded partnerships under current law, or the treatment of income on loaned securities or fixed-term securities loans under current law.

The proposal would be effective for taxable years beginning after December 31, 2023.

Amend the Mark-To-Market Rules to Include Digital Assets

Current Law

Section 475 of the Internal Revenue Code requires dealers in securities to use the mark-to-market method of accounting for inventory and non-inventory securities held at year end. For this purpose, a security includes corporate stock, interests in widely held or publicly traded partnerships and trusts, debt instruments, and certain derivative financial instruments. Dealers in commodities and traders in securities or commodities may elect to use the mark-to-market method. A commodity means any commodity which is actively traded, any notional principal contract with respect to any such commodity, and certain other derivative financial instruments and hedges with respect to such commodities.

Gain or loss on dealer securities is generally treated as ordinary income or loss, unless the security is (a) a security held for investment or not held for sale or a hedge of a non-security, if properly identified as such, or (b) is held other than in connection with securities dealer activities. Gain or loss on other assets that are marked to market pursuant to an election also generally is treated as ordinary income or loss. Limitations on the deductibility of capital losses therefore

generally do not apply to losses on assets marked to market under these rules. Several anti-abuse rules addressed to timing and character arbitrage do not apply to securities that are marked to market under these rules.

Reasons for Change

Mark-to-market accounting generally provides a clear reflection of income with respect to assets that are traded in established markets. For market-valued assets, mark-to-market accounting imposes few burdens and offers few opportunities for manipulation. Exchange-traded assets typically have reliably determinable values if they are actively traded. For financial accounting purposes, taxpayers may be required to mark inventory or trading positions to market, including at year-end. To the extent that financial accounting valuation is consistent with the determination of fair market value for tax purposes, allowing taxpayers to use their financial accounting valuations for tax purposes may reduce tax compliance costs.

Thousands of different digital assets are currently in existence. While many of them are illiquid, some of them are traded in high volumes and may have reliable valuations. Allowing taxpayers to mark actively traded digital assets to market would clearly reflect income and could reduce tax compliance burdens, just as current law does for other assets of commodities dealers and securities traders. Notably, for financial accounting purposes, taxpayers may be required to mark inventory or trading positions to market, including at year-end.

Proposal

The proposal would add a third category of assets that may be marked-to-market at the election of a dealer or trader in those assets. Assets in the third category would be actively traded digital assets and derivatives on, or hedges of, those digital assets, under rules similar to those that apply to actively traded commodities. The Secretary and her delegates would have authority to determine which digital assets are treated as actively traded. The determination of whether a digital asset is actively traded would take into account relevant facts and circumstances, which may include whether the asset is regularly bought and sold for U.S. dollars or other fiat currencies, the volume of trading of the asset on exchanges that have reliable valuations, and the availability of reliable price quotations.

A digital asset would not be treated as a security or commodity for purposes of the mark-to-market rules and

APPENDIX. GREEN BOOK PROPOSALS (Cont'd)

would therefore be eligible for mark-to-market treatment only under the rules applicable to the new third category of assets. No inference is intended as to the extent to which a digital asset may be eligible for mark-to-market treatment under current law.

The proposal would be effective for taxable years beginning after December 31, 2023.

ENDNOTES

¹ Revenue Ruling 2008-5, 2008-1 C.B. 271.

² This definition is the same as that provided in section 6045(g)(3)(D). It is intended that the Secretary may exercise her authority to provide that the term "digital asset" has a meaning for wash sale purposes that is not identical to its meaning for purposes of regulations issued under section 6045.

³ *Samueli v. Commissioner*, 619 F.3d 399 (9th Cir. 2011) (tax-motivated transaction in which a taxpayer ostensibly loaned a debt instrument

for most of its remaining term and did not qualify for non-recognition treatment under section 1058); *Sollberger v. Commissioner*, 691 F.3d 1119 (9th Cir. 2011) (tax-motivated transaction in which a taxpayer did not receive amounts in respect of distributions where security was nominally loaned for 7 years and did not qualify for non-recognition treatment under section 1058); *Lizzie Calloway*, 135 T.C. 26 (2010) (tax-avoidance transaction in which securities were nominally loaned for three years and did not meet the requirements of section 1058), affirmed on other grounds, 691 F.3d 1215 (11th Cir. 2012).

⁴ *Samueli v. Commissioner*, 619 F.3d 399 (9th Cir. 2011).

⁵ A hard fork is a significant change to the protocol of a blockchain network that effectively results in two different digital assets with a common history. Holders of the digital asset in the original blockchain have access to both the original digital asset and the digital asset on the new blockchain after the hard fork.

⁶ An airdrop means the transfer of a typically free digital asset to a taxpayer's wallet, generally with no or minimal involvement by the transferee, for example in order to promote or market a new digital asset.

ENDNOTES

* The information in this article is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

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¹ For example, this article will not discuss proposals affecting the taxation of insurance products or insurance companies, nor will it consider provisions broadly relevant to the U.S. federal income tax system, such as the proposals to (i) reform the taxation of capital income, (ii) increase corporate and individual income tax rates, and (iii) impose minimum taxes on wealthy taxpayers, even though these provisions have significant bearing on the taxation of financial products.

² There is a "Netting Rule" that states the value of stock treated as repurchased during the taxable year for purposes of computing the excise tax is reduced by the value of any new issuances of stock by the corporation during the same taxable year. There are also six exceptions to the excise tax under the statute: (i) to the extent a

repurchase is part of a reorganization under Code Sec. 368(a) and no gain or loss is recognized by the shareholder; (ii) if the stock repurchased or an amount of stock equal to the value of such stock is contributed to an employer-sponsored retirement plan, an employee stock ownership plan, or similar plan; (iii) if the total value of the stock repurchased during the tax year does not exceed \$1 million; (iv) under regulations prescribed by Treasury, repurchases by dealers in securities in the ordinary course of business (the "Dealer Exception"); (v) repurchases by regulated investment companies ("RICs") or real estate investments trusts ("REITs"); and (vi) repurchases treated as dividends.

³ IRB 2023-3, 374 (Dec. 27, 2022).

⁴ See Andrew Velarde, *Commentators Want Excise Tax Per Se Funding Rule Axed*, 178 TAX NOTES FEDERAL 2247 (Mar. 27, 2023).

⁵ www.cnn.com/2023/02/10/investing/premarket-stocks-trading/index.html.

⁶ See Andrew Velarde, *IRS 'Seriously Considering' Changes to Excise Tax Funding Rule*, 179 TAX NOTES FEDERAL 1057 (May 8, 2023).

⁷ Code Sec. 861(a)(2).

⁸ Income arising from a notional principal contract is generally sourced to the residence of the recipient of the payment. Reg. §1.863-7(b)(1). See also Sheppard, *To Withhold or Not to Withhold on Equity Swaps*, 55 TAX NOTES 1719 (Jun. 29, 1992); May, *Flying on Instruments: Synthetic Investments and Withholding Tax Avoidance*, 73 TAX NOTES 1225, 1234 & n.53 (Dec. 9, 1996); Penn, *Withholding Tax Issues in Cross-Border Equity Swaps: The Dividend Problem* (Oct. 11, 1993) (available as 93 TNI 196-14 from TAX ANALYSTS).

⁹ A dividend equivalent for these purposes is generally a payment that is contingent upon, or

determined by reference to, the payment of a U.S. source dividend arising from (i) a substitute dividend payment made pursuant to a securities lending or sale-repurchase transaction, (ii) payments made pursuant to a "specified notional principal contract," (iii) payments made pursuant to a "specified equity-linked instrument," or (iv) other substantially similar payments. Regulations under Code Sec. 871(m) provide special rules and definitions to apply with respect to specified notional principal contracts and specified equity-linked instruments for these purposes.

¹⁰ Under Code Sec. 7704, publicly traded partnerships are treated as corporations unless they meet certain passive-type income requirements. The remainder of this article assumes that any publicly traded partnership described is classified as a partnership for U.S. federal income tax purposes.

¹¹ See Sec. 138146 of the Build Back Better Act.

¹² Frequently miners form "mining pools" to pool their efforts and split the rewards.

¹³ For an accessible discussion of blockchain technology and the types of attacks that a PoW system defends against, see Matt Levine, *The Only Crypto Story You Need*, Bloomberg, available at www.bloomberg.com/features/2022-the-crypto-story/.

¹⁴ The Ethereum blockchain previously used a PoW system but has recently transitioned to a PoS system. For further discussion, see Peter Ritter, Nelson Suit, Joshua Tompkins, & Hubert Raglan, *Year-End Tax Considerations for Cryptocurrency Investors*, J. TAX'N FIN. PROD. 19, 3 (2022).

Significantly, a PoW blockchain is susceptible to attack if a single person or entity controls

more than 50 percent of the total mining power, because that person or entity would be able to rewrite the transaction information. This attack is known as a “51 percent attack.” Due to the relative size of Bitcoin, it is difficult for new blockchains to effectively use a PoW system because a small fraction of Bitcoin mining power could successfully employ a 51 percent attack. See www.crypto51.app/ for an indication of the theoretical cost of 51 percent attack on various blockchain networks.

¹⁵ See Bitcoin Energy Consumption Index, digi-conomist.net/bitcoin-energy-consumption/.

¹⁶ There are, however, drawbacks to PoS systems. For further discussion, see K. Peter Ritter & Joshua S. Tompkins, *Proof of Stake—What’s Really at Stake on the Tax Front?*, J. TAX’N FIN. PROD. 19, 1 (2022).

¹⁷ The excise tax would be phased in over three years at a rate of 10 percent in the first year, 20 percent in the second, and 30 percent thereafter.

¹⁸ The controversy between PoW and PoS is perhaps best illustrated by the events surrounding the Ethereum “merge” (Ethereum’s transition to PoS). Shortly after the transition, there was a hard fork (a division in the blockchain) and certain parties reverted back to a PoW system for various ideological, technological, and economic reasons. For further discussion, see Peter Ritter, Nelson Suit, Joshua Tompkins, & Hubert Raglan, *Year-End Tax Considerations for Cryptocurrency Investors*, J. TAX’N FIN. PROD. 19, 3 (2022).

¹⁹ The relatively cleanness of U.S. mining is driven by a number of factors, including that U.S. based miners may be more prone to using sustainable sources of power. According to a 2022 report issued by the Bitcoin Mining Council, the percentage of energy consumed by the bitcoin mining community derived from sustainable sources increased to 64.8%. bitcoinminingcouncil.com/bitcoin-mining-council-survey-confirms-year-on-year-improvements-in-sustainable-power-mix-and-technological-efficiency-in-q4-2022/.

²⁰ For example, Chinese government actions led to a significant migration of mining power out of China and into the U.S. See www.npr.org/2022/02/24/1081252187/bitcoin-cryptocurrency-china-us.

At the time, this was hailed as an environmental boon because it resulted in much “cleaner” mining activities because Chinese mining was powered largely by coal power plants.

²¹ After the U.S., the countries with the most mining activity are Kazakhstan and Russia. These countries have comparatively less green energy production and are generally expected to absorb any drop in U.S. mining capacity.

²² It is possible that the proposal reflects a belief on the part of the drafters that the digital asset industry does not create value or provide practical utility. Although this interpretation is somewhat in conflict with the Green Book text, it would explain why a particular industry was targeted. While we do not necessarily agree with

this implication, we note that if that is the case, there may be more effective ways of discouraging the industry or reducing its environmental impacts. For example, the government could use regulation to impose clean energy requirements or require digital asset miners to purchase carbon offsets.

²³ Code Sec. 1091(d); Reg. §1.1091-2 and Code Sec. 1223(3); Reg. §1.1223-1(d).

²⁴ GCM 34630 (Oct. 04, 1971); Rev. Rul. 71-568, 1971-2 CB 312. See also *Corn Products Refining Co.*, CA-2, 54-2 USTC ¶166,082, 215 F2d 513 (1954); *Sicanoff Vegetable Oil Co.*, 27 TC 1056, Dec. 22,310 (1957), *rev’d on other grounds* CA-7, 58-1 USTC ¶9233, 251 F2d 764 (1958).

²⁵ Rev. Rul. 74-218, 1974-1 CB 202.

²⁶ Rev. Rul. 2008-5, 2008-1 CB 271.

²⁷ Sec. 138152(a) of the Build Back Better Act.

²⁸ *Id.*

²⁹ *Id.*

³⁰ The potential for wash sale avoidance can be illustrated by the following example:

Facts: On October 15, 2022, Party A sells specified asset X with a basis of \$100 for \$25, its fair market value. On October 16, 2022, Party B, a non-spousal related party, buys specified asset X for \$25 and continues to hold it. On October 17, 2022, Party A buys specified asset X for \$25 and immediately sells it for \$25.

Analysis: Assuming the October 15, 2022 sale by Party A and the October 16, 2022 purchase by Party B is not treated as an indirect sale by Party A to Party B, the purchase by Party B will create a wash sale. As a result, the \$75 loss Party A realized on October 15, 2022 is disallowed. Because Party B is not Party A’s spouse, Party B is not entitled to increase its basis in specified asset X by the amount of the disallowed loss. Party A’s purchase of specified asset X on October 17, 2022, does not create a wash sale because the October 15, 2022 sale and October 16, 2022 purchase were already treated as a wash sale. However, under the basis adjustment rule, Party A’s basis in the specified asset X acquired on October 17, 2022 is increased by the amount of the loss disallowed in the wash sale (i.e., basis is increased from \$25 to \$100). When Party A then sells the October 17, 2022 lot, a \$75 loss is realized. Thus, Party A is able to take the loss on specified asset X by increasing its exposure for less than a day (and never eliminating the Party A/B economic exposure), and related Party B maintains its cost basis of \$25.

See Tompkins & Dyor, *Related-Party Wash Sale Transactions—An Evaluation of the Current State of the Law and Recent Legislative Proposals*,

J. TAX’N FIN. PROD. 19, 2 (2022) for further discussion.

³¹ See New York State Bar Association, *Report No. 1456—Comments on Wash Sale Provisions of the House Proposals for the Build Back Better Act* (Jan. 14, 2022).

³² See, e.g., L. Farr & M.S. Farber, *Dirty Linen: Airing Out the Wash Sale Rules*, J. TAX’N FIN. PROD. 3, 3 (2002).

³³ Code Sec. 1091(d) states:

If the [acquired] property consists of stock or securities the acquisition of which (or the ... option to acquire which) resulted in the nondeductibility ... of loss from the sale ... of substantially identical stock or securities, then the basis shall be the basis of the stock or securities so sold ... increased or decreased ... by the difference, if any, between the price at which the property was acquired and the price at which such substantially identical stock or securities were sold ...

In situations where a taxpayer sells stock and enters into an option to acquire such stock, Code Sec. 1091(d) does not appear to tack basis to the option, instead (read literally) it tacks basis only on stock or securities acquired through the exercise of that option. Obviously, this would be a harsh result ungrounded in any policy concern and we are unaware of the IRS taking this position.

³⁴ See Sec. 138152(d) of the Build Back Better Act (“Nothing in this section or the amendments made by this section shall be construed to create any inference with respect to the proper treatment of related parties under Code Sec. 1091 of the Internal Revenue Code of 1986 with respect to sales, dispositions, and terminations before January 1, 2022.”).

³⁵ Frequently, the rebate fee will exceed the borrow fee and the two will be netted with only one party making a payment to the counterparty. The tax characterization of rebate fees and borrow fees is not clear, but general market practice is to treat the net payment as interest in the common situation where the rebate fee exceeds the borrow fee. See SIFMA, *Re: Guidance on Securities Loan and Repo Payments*, available at: www.sifma.org/resources/submissions/sifma-submits-comments-to-the-us-department-of-treasury-and-the-irs-requesting-guidance-on-securities-loan-and-repo-payment/.

³⁶ Code Sec. 1058(a).

³⁷ *Id.*

³⁸ Code Sec. 1058(a); Code Sec. 1236(c).

³⁹ See Proposed Reg. §1.1058-1(e)(1).

⁴⁰ This assumes that the publicly traded partnership is not classified as a C corporation. See Code Sec. 7704.

⁴¹ See ABA *Committee Reports on Securities Lending Transactions*, 91 TNT 107-33 (May 15, 1991) (“In general, Code Sec. 1058(a) provides

that no gain or loss is recognized by the owner of securities when the owner transfers securities for the contractual obligation of the borrower to return identical securities. It constitutes a safe harbor from the recognition of gain or loss where a taxpayer exchanges securities pursuant to an agreement that meets the statutory requirements.”); *NYSBA Tax Section Report Addresses Treatment of Securities Loans*, 2011 TNT 112-22 (June 10, 2011) (“There is nothing in the language of [Code Sec. 1058] itself or the history of the statute to suggest that it was intended to be more than a safe harbor.... In our view, section 1058 should operate as a safe harbor.”).

⁴² See Proposed Reg. §1.1058-1(e)(1) (“If a transfer of securities is intended to comply with Code Sec. 1058 and fails to do so because the contractual obligation does not meet the requirements of Code Sec. 1058(b) and Reg. §1.1058-1(b), gain or loss is recognized in accordance with Code Sec. 1001 and Reg. §1.1001-1(a) upon the initial transfer of the securities.”).

⁴³ Similar arguments would apply in the case of publicly traded partnership interests.

⁴⁴ Much of the guidance in this area has focused on the tax consequences to the short seller, but arguably there should be parity between the two parties. The general rule is that an in lieu payment is deductible by the short seller and does not result in a basis adjustment. See *e.g.*, Rev. Rul. 60-177, 1960-1 CB 9 (“[T]he ‘short-seller’ is required to pay the lender an amount equal to the cash dividend on the stock borrowed to cover the short sale while the stock is on loan. Such an amount, commonly known as a ‘short dividend,’ is credited to the lender’s account by his broker. The ‘short-seller’ is entitled to a deduction, for Federal income tax purposes, for the amount which he paid to the lender.”). However, the IRS’s position appears to be that in lieu payments with respect to return of capital distributions are capital expenditures of the short seller, rather than deductible expenses. See Rev. Rul. 72-521, 1972-2 CB 178 (“The additional shares purchased in the case of a nontaxable stock dividend as well as the compensating

payment in the case of a liquidating dividend are each in the nature of a repayment of principal. The amount paid in either case is part of the cost of replacing the borrowed stock and is, hence, a capital expenditure.”); GCM 38604 (Jan. 09, 1981) (“Any expenditures incurred by the short seller to obtain securities for delivery in the short sale should be capitalized (added to the cost of the covering transaction) rather than immediately deducted.”). In *Main Line Distributors, Inc.*, CA-6, 63-2 USTC ¶9655, 321 F2d 562 (1963), the court rejected the IRS’s position that a nontaxable distribution was a capital expenditure, stating: “[I]t is our view that the [in lieu] payment is allowed as a deduction, not because it is a repayment of a particular kind of ‘dividend’ which the lender would have received if the stock had not been borrowed, but because it is a repayment to the lender of what he has lost by lending his stock to the borrower, which the borrower is obligated to repay by reason of his contract with the lender. It is a contractual expense incurred by the taxpayer as a necessary cost of obtaining for a temporary period the use of the stock of another, irrespective of whether it is a taxable or nontaxable dividend to the purchaser.” The court went on to deny the taxpayer’s deduction on other grounds, but the discussion quoted above does inject a degree of uncertainty as to the proper treatment of an in lieu payment in respect of a nontaxable distribution (such as a return of capital). For further discussion, see Jeff Maddrey, *Accounting for Income from Securities Lending Transactions*, J. TAX’N FIN. PROD. 12, 2 (2014).

⁴⁵ Code Sec. 475(a).

⁴⁶ Code Sec. 475(d)(3)(A)(i).

⁴⁷ Code Sec. 475(c)(2).

⁴⁸ Notice 2014-21, IRB 2014-16, 938.

⁴⁹ As a technical matter, this may not necessarily be true in all cases. Included in the definition of a security under Code Sec. 475(c)(2)(C) is any “note, bond, debenture, or other evidence of indebtedness.” Some commentators have suggested that “traditional” (non-algorithmic) stablecoin investments could be classified as debt instruments because holders have a

legally enforceable claim to demand that the sponsor redeem its stablecoin for U.S. dollars, and have a reasonable expectation that the sponsor will have sufficient liquid assets to meet a redemption demand. See New York State Bar Association, *Report No. 1461—Report on Cryptocurrency and Other Fungible Digital Assets* (Apr 18, 2022). However, given the “stable” nature of stablecoins, this point appears to be more academic than practical because there would presumably be only trivial market adjustments for such assets.

⁵⁰ Code Secs. 475(e), (f), respectively.

⁵¹ Also included in the definition of a “commodity” is any notional principal contract with respect to any actively traded commodity, and certain other derivative financial instruments and hedges with respect to such commodities. Code Sec. 475(e)(2)(B)-(D).

⁵² For a more detailed discussion of the tax implications of this determination, see Vadim Novik, *Hot Commodities and Hotshot Market Makers: Why Should I Care Whether Virtual Currencies Are Commodities for Purposes of Section 475?*, TAX’N FIN. PROD. TRANS. 2022, Chapter 8.

⁵³ See, *e.g.*, *MoneyGram Int’l, Inc.*, CA-5, 2021-1 USTC ¶150,159, 999 F3d 269, 274 (2021).

⁵⁴ One obvious exception to this general rule would be non-fungible tokens (“NFTs”).

⁵⁵ The question of whether intangible property such as a digital asset can be a “commodity” is reminiscent of the jurisdictional battle in the late 1970’s and early 1980’s between the SEC and CFTC over the classification of financial instruments such as Treasuries and GNMA’s as “commodities” for purposes of regulating futures contracts on those assets, a battle that finally was resolved by a jurisdictional accord reached between the SEC and CFTC in the Futures Trading Act of 1982, P.L. No. 97-444. See, *e.g.*, *Board of Trade of the City of Chicago v. Securities and Exchange Comm’n*, CA-7, 677 F2d 1137 (1982), *vacated as moot*, SCT, 459 US 1026, 103 SCt 434 (Nov. 29, 1982).

⁵⁶ See New York State Bar Association, *Report No. 1461—Report on Cryptocurrency and Other Fungible Digital Assets* (Apr. 18, 2022).

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