

110TH CONGRESS  
1ST SESSION

# H. R. 4912

To amend the Internal Revenue Code of 1986 with respect to the treatment of prepaid derivative contracts.

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IN THE HOUSE OF REPRESENTATIVES

DECEMBER 19, 2007

Mr. NEAL of Massachusetts introduced the following bill; which was referred to the Committee on Ways and Means

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## A BILL

To amend the Internal Revenue Code of 1986 with respect to the treatment of prepaid derivative contracts.

1 *Be it enacted by the Senate and House of Representa-*  
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. TREATMENT OF PREPAID DERIVATIVE CON-**  
4 **TRACTS.**

5 (a) IN GENERAL.—Part V of subchapter P of chapter  
6 1 of the Internal Revenue Code of 1986 (relating to spe-  
7 cial rules for bonds and other debt instruments) is amend-  
8 ed by adding at the end the following new subpart:

9 **“Subpart E—Prepaid Derivative Contracts**

“Sec. 1289. Treatment of prepaid derivative contracts.

“Sec. 1289A. Definitions.

1 **“SEC. 1289. TREATMENT OF PREPAID DERIVATIVE CON-**  
2 **TRACTS.**

3 “(a) **CURRENT INCLUSION IN INCOME.**—For pur-  
4 poses of this title, there shall be included in the gross in-  
5 come of the holder of a prepaid derivative contract an  
6 amount equal to the holder’s interest accrual amount with  
7 respect to such contract for the taxable year. Any amount  
8 included in gross income under the preceding sentence  
9 shall be treated as interest.

10 “(b) **BASIS ADJUSTMENTS.**—If any interest accrual  
11 amount is included in the gross income of the holder of  
12 a prepaid derivative contract under subsection (a), such  
13 holder’s basis in such contract shall be increased by the  
14 amount so included.

15 “(c) **LOSS TREATED AS ORDINARY TO EXTENT OF**  
16 **BASIS INCREASES.**—In the case of any loss recognized on  
17 the disposition of any prepaid derivative contract, so much  
18 of such loss as does not exceed the aggregate increases  
19 in the basis of such contract under subsection (b) shall  
20 be treated as an ordinary loss.

21 “(d) **TREATMENT OF DISTRIBUTIONS.**—In the case  
22 of any distribution under a prepaid derivative contract—

23 “(1) except as provided in paragraph (3), such  
24 distribution shall not be includible in gross income,

1           “(2) the adjusted basis of such contract shall be  
2 reduced (but not below zero) by the amount of such  
3 distribution, and

4           “(3) the excess (if any) of such distribution  
5 over such adjusted basis (determined before any re-  
6 duction under paragraph (2)) shall be treated as  
7 gain from the sale of such contract.

8 For purposes of this subsection, adjusted basis shall be  
9 determined after any adjustment to such basis under sub-  
10 section (b) for the taxable year.

11       “(e) INTEREST ACCRUAL AMOUNT.—

12           “(1) IN GENERAL.—For purposes of this sec-  
13 tion, the interest accrual amount with respect to any  
14 prepaid derivative contract for any taxable year is  
15 the product of—

16           “(A) the holder’s adjusted basis in such  
17 contract as of the beginning of such taxable  
18 year, multiplied by

19           “(B) the greater of—

20           “(i) the monthly Federal short-term  
21 rate determined under section 1274(d) for  
22 the first month ending during such taxable  
23 year, or

1                   “(ii) in the case of a contract under  
2                   which notional amounts are credited, the  
3                   rate at which such amounts are credited.

4                   “(2) PRORATION OF INTEREST ACCRUAL  
5                   AMOUNT.—In the case of a taxpayer who acquires or  
6                   disposes of any prepaid derivative contract during  
7                   the taxable year, the interest accrual amount deter-  
8                   mined under paragraph (1) with respect to such con-  
9                   tract for such year shall be an amount which bears  
10                  the same ratio to—

11                  “(A) the amount which would be so deter-  
12                  mined without regard to this subparagraph, as

13                  “(B) the portion of such taxable year dur-  
14                  ing which such contract was held by such tax-  
15                  payer bears to the entire taxable year.

16                  “(3) ADJUSTED BASIS DETERMINED AT ACQUI-  
17                  SITION.—In the case of the acquisition of any pre-  
18                  paid derivative contract during the taxable year,  
19                  paragraph (1) shall be applied by substituting ‘the  
20                  acquisition of such contract’ for ‘the beginning of  
21                  such taxable year’.

22                  “(f) SPECIAL RULES FOR PUBLICLY TRADED PRE-  
23                  PAID DERIVATIVE CONTRACTS.—

24                  “(1) LIMITATION ON INCLUSION.—The amount  
25                  includible under subsection (a) with respect to the

1 holder of any publicly traded prepaid derivative con-  
2 tract for any taxable year shall not exceed the excess  
3 (if any) of—

4 “(A) the sum of—

5 “(i) the fair market value of such con-  
6 tract as of the close of such taxable year  
7 (or, in the case of the disposition of such  
8 contract during the taxable year, as of  
9 such disposition), plus

10 “(ii) any distributions to the holder  
11 under such contract during such taxable  
12 year, over

13 “(B) the holder’s adjusted basis in such  
14 contract as of the close of the preceding taxable  
15 year (or, in the case of the acquisition of the  
16 contract during the taxable year, as of such ac-  
17 quisition).

18 “(2) EXCESS CARRIED FORWARD.—If the inter-  
19 est accrual amount with respect to any publicly trad-  
20 ed prepaid derivative contract for any taxable year  
21 exceeds the limitation determined under paragraph  
22 (1) with respect to the holder of such contract for  
23 such year, the interest accrual amount of such hold-  
24 er with respect to such contract for the succeeding  
25 taxable year shall be increased by such excess.

1           “(3) INTEREST ACCRUAL AMOUNT IN SUC-  
2           CEEDING YEARS UNAFFECTED BY LIMITATION.—  
3           Solely for purposes of subsection (e)(1), the adjusted  
4           basis in a publicly traded prepaid derivative contract  
5           shall be determined without regard to paragraph (1).

6           “(g) EXCEPTION FOR SHORT HOLDING PERIODS  
7           AND INSTRUMENTS MARKED TO MARKET.—This section  
8           shall not apply to any prepaid derivative contract for any  
9           taxable year if such contract—

10           “(1) has been held for less than 1 year and is  
11           disposed of in the taxable year in which acquired or  
12           on or before the due date for the return of income  
13           tax for such taxable year (without regard to any ex-  
14           tension of time for filing such return), or

15           “(2) is marked to market with respect to the  
16           taxpayer for such taxable year under section 475 or  
17           1256 or any other provision of this title.

18           “(h) REGULATIONS.—The Secretary shall issue such  
19           regulations as are necessary or appropriate to carry out  
20           the purposes of this section, including regulations to pre-  
21           vent the avoidance of the purposes of this section.

22           **“SEC. 1290. DEFINITIONS.**

23           “For purposes of this subpart—

24           “(1) PREPAID DERIVATIVE CONTRACT.—

1           “(A) IN GENERAL.—The term ‘prepaid de-  
2           rivative contract’ means any prepaid contract  
3           with a term of longer than 1 year from the date  
4           of issue which is a derivative financial instru-  
5           ment with respect to—

6                   “(i) any security (as defined in section  
7                   475(e)(2), determined without regard to  
8                   subparagraph (F) and the last sentence  
9                   thereof) or group of securities (as so de-  
10                  fined),

11                  “(ii) any commodity (as defined in  
12                  section 475(e)(2), determined without re-  
13                  gard to subparagraph (D) thereof) or  
14                  group of commodities (as so defined), or

15                  “(iii) any financial index.

16           “(B) EXCEPTIONS.—Such term shall not  
17           include any instrument which is treated (for  
18           purposes of this title) as—

19                   “(i) stock or debt,

20                   “(ii) an interest in a partnership,

21                   “(iii) part of a constructive ownership  
22                  transaction to which section 1260 applies,

23                   “(iv) a hedging transaction (as de-  
24                  fined in section 1256(e)(2)),

25                   “(v) a notional principal contract, or

1 “(vi) an option.

2 “(C) CERTAIN OPTIONS ECONOMICALLY  
3 SIMILAR TO OWNERSHIP.—To the extent pro-  
4 vided by the Secretary in regulations or other  
5 guidance, any option which by reason of such  
6 option’s term and strike price is economically  
7 similar to a prepaid contract described in sub-  
8 paragraph (A) shall not be treated as an option  
9 for purposes of subparagraph (B)(vi).

10 “(2) PREPAID CONTRACT.—The term ‘prepaid  
11 contract’ means any contract under which there is  
12 no substantial likelihood that the taxpayer will be re-  
13 quired to pay any additional amount under the con-  
14 tract. For purposes of the preceding sentence, a tax-  
15 payer shall not be treated as having a substantial  
16 likelihood of being required to pay any additional  
17 amount if those additional amounts have been set  
18 aside (or are expected to be set aside) with respect  
19 to such payment or are subject to a defeasance ar-  
20 rangement or other arrangement similar to an ar-  
21 rangement described in section 470(d)(1)(B).

22 “(3) PUBLICLY TRADED PREPAID DERIVATIVE  
23 CONTRACT.—The term ‘publicly traded prepaid de-  
24 rivative contract’ means any prepaid derivative con-  
25 tract—

1           “(A) which is traded on or subject to the  
2 rules of a qualified board or exchange, or

3           “(B) with respect to which the issuer (or  
4 any person acting on behalf of the issuer) regu-  
5 larly makes available to the public (including  
6 customers or subscribers) bid or offer quotes  
7 and stands ready to effect buy or sell trans-  
8 actions at the quoted prices for itself or on be-  
9 half of others.”.

10 (b) CONFORMING AMENDMENTS.—

11           (1) The table of subparts for part V of sub-  
12 chapter P of chapter 1 of such Code is amended by  
13 adding at the end the following new item:

          “SUBPART E—PREPAID DERIVATIVE CONTRACTS.”.

14           (2) The heading of part V of subchapter P of  
15 chapter 1 of such Code, and the item relating to  
16 such part in the table of parts for subchapter P of  
17 chapter 1 of such Code, are each amended by strik-  
18 ing “debt”.

19           (c) EFFECTIVE DATE.—The amendments made by  
20 this section shall apply to contracts acquired after the date  
21 of the enactment of this Act.

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